

# CORONA ECONOMICS

## The Five Horsemen of the Apocalypse

*Revised English Edition*



Velimir  
Šonje

Kristijan  
Kotarski



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of the Apocalypse

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Velimir Šonje & Kristijan Kotarski | Corona Economics:  
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Velimir Šonje and Kristijan Kotarski /  
Corona Economics: The Five Horsemen of the Apocalypse

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## EDITOR'S NOTE

Society is sustained by an intricate web of tensions, interests, and forces acting in opposition to one another. In times of relative stability, these tensions are generated to subtle degrees that can go unnoticed by most people. But when crisis strikes, they usually explode into immense earthquakes that create new social, economic, and political cleavages.

This has been the case with the coronavirus pandemic. A physical phenomenon by any other name, the outbreak of the virus has exacerbated existing socio-economic inequalities and accelerated far-reaching technological transformations, such as digitalisation. The aftershocks of the virus on already strained public finances and frail social security systems will be felt for years, regardless of how and when the pandemic will end.

In politics, the pandemic has unlocked new chapters of a philosophical debate about the value of liberalism, democracy, and science as well as their mutual relationships. Are civil liberties and personal freedoms absolute? If not, who decides when and how to abridge them? What constitutes a state of emergency? What degree of legitimacy can science provide to political decisions, when scientific knowledge is circumscribed by time-limits and mere circumstances? These are all valid discussion points that require rational and meticulous examination. Nevertheless, for the past year, this discussion has been overridden by fear, emotions, and limited information.

When the pandemic was first confirmed, self-preservation instincts kicked in. In a global communication environment defined by the real-time, free flow of information, fear spreads faster than any virus ever could. Combined with the fact that scientific knowledge of the virus was limited, the fear of infection eclipsed every other argument in the public debate. Naturally, the call to protect ourselves and others from infection was prioritised.

Eventually, the discussion about state responses to the pandemic was shrouded by a moralistic dilemma with ideological overtones. Lockdowns and other restrictions of individual freedoms became idealised as the 'right thing to do', a matter of belief in social ideals and the 'higher good'. After that point, scrutinising scientific

data or political decisions, or both, was the shortest way to being branded as irresponsible, insensitive, and even ‘fascist’.

It may be argued that the combination of fear, lack of information, and shallow moralizing did nothing to help our societies deliberate and develop adequate public health policies. On the contrary, downgrading dissenting voices *prima facie* suppressed public discussion and encouraged a continuous sense of panic in society.

Given the toxicity of the debate all over Europe and the world, this book is erecting a monument to intellectual courage. It is not only attempting to analyse and synthesize the data available from various sources in a way that will make sense to non-experts but also, and more importantly, re-establish a familiar degree of sobriety in the public debate. Sooner or later, our societies will be able to evaluate the policy responses to the coronavirus pandemic, the *raison d’être* of the lockdowns, and the necessity of unprecedented limitations to individual freedoms. It is preferable that this evaluation takes place in the context of an open, moderate, and evidence-based debate, rather than being hijacked by conspiracy theories and the politics of fear and resentment.

In this context, the authors examine the external and internal factors that have put pressure on the decision-making process and the very fundamental values that underlie liberal democracy in Europe. In the first and second parts, the discussion focuses on the roles of ideology and China during the pandemic. Although this may not be apparent at first glance, the two issues are actually intertwined: the initial Chinese response to the outbreak of the virus in Wuhan influenced public policies in Europe. Here, the uncomfortable truth is that European liberal democracies copied from the playbook of a totalitarian, dictatorial government that required complete subservience to the state. In the third part – which lends itself to the somewhat sarcastic title of the book – the authors then identify and highlight five risks associated with the adoption of public policies modelled on the Chinese totalitarian approach.

The five horsemen of the apocalypse, as the authors call these risks, are five terribly bad ideas that could transform our societies as we know them. Partly inspired by the Chinese model, these ideas assume that the fallout from the pandemic and from our public policy choices can be alleviated with a combination of ‘helicopter money’, trade protectionism, and a heavy-duty nanny state that curtails civil liberties. Ultimately, the dangerous logic underlying these ideas is one that discredits the European Union and the liberal democratic values on which it is built.

The discussion herein is not conclusive by any stretch of the imagination. For one, the authors draw on real-life examples from their own national context (Croatia). However, albeit not similarly in every detail, the same basic argumentation has underlined public debates about the pandemic everywhere in Europe. Hence, readers in Greece, Belgium, and elsewhere will be able to identify with both the timeline and the examples put forth. Second, despite the authors' earnest attempt to take into account the latest data, the numbers are being updated with every passing moment. New trends are identified and policies change from one day to the next. No publication process could ever catch up with the speed of the events unfolding across Europe and the world. By the same token, no single analysis could hope to take in the full breadth of national particularities that are so characteristic of our continent.

Nevertheless, *Corona Economics: The Five Horsemen of the Apocalypse* makes a number of solid contributions to current debates about an issue that will top political agendas for many years to come. The book illustrates how, in extreme circumstances of fear and limited information, excessive ideology and artificial moral dilemmas in the public debate can cloud the judgement of decision-makers. It demonstrates that public health policies are not simply a matter of expert opinion, but they carry social consequences that need to be considered. In this way, it calls for balance in the relationship between experts and policymakers. Most of all, this book makes the case for renewed moderation in our approach towards the coronavirus pandemic.

Out of the many things that the COVID-19 crisis rendered obvious beyond demonstration, no matter how enlightened or liberal the State is assumed to be, it always carries within the potential for oppression. In a prolonged state of emergency or, worse, a permanent 'war' against an invisible enemy, authoritarian instincts can kick in like a sleep twitch. As the authors seem to imply, the real 'apocalypse' may not be the pandemic itself but the social and political transformations that it may inflict upon our liberal democracies.

Dr Antonios Nestoras  
European Liberal Forum  
Brussels, 15 April 2021

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## PREFACE

March and April 2020 saw the outset of the coronavirus pandemic, a health emergency unprecedented for generations. The fine civilizational fabric made up of economic and financial systems, political institutions, trust in experts, convictions and moral attitudes faced a serious test, to say the least. It shattered like broken glass before our very eyes.

Under such conditions, it was only natural to try to understand what was going on, predict the future and adapt. This reflex gave birth to a series of texts published in Croatian language on *Ekonomski lab* website between 1 March and 15 May 2020. The paper edition, entitled *Koronaekonomika: pet jahača apokalipse*, was released in July that year. The book can be seen as evidence of a quest for answers in a world torn between the natural concern about the sick and the elderly on the one hand and the equally natural concern about the prospects of active people and the generations to come on the other. Equally important was the intention to contain the outbreak and preserve individual rights and freedoms at the same time, as well as the intention that societies remain open without using this openness for fearmongering and propagation of authoritarian political ideas that thrive when fear reigns in society.

The dilemmas triggered at the beginning of the pandemic escalated between early summer 2020 (when the Croatian edition of this book was published) and February 2021 (when English-language edition was near completion). Despite the development of the vaccine, many countries are closed at the moment. The measures in some of them are more stringent than in April 2020. The public is sharply divided: while some see radical lockdown as the only solution, others estimate that the social losses arising from the lockdown exceed the benefit of saved lives.

The attitude towards the pandemic and reactions to it is an ethical problem. The losses in question are much broader than the economic concept of “loss”. This is not only about lost economic growth, jobs and growing public debt. This is also about human lives, deterioration of health and serious risks for the impoverished people who are losing their jobs, growing domestic violence, diminished efficiency of prevention in health care and timely diagnostics and

therapies, and the loss of expected remaining years of healthy life due to poorer or shorter education resulting from closed schools or online education at home (primarily affecting the children from the families of lower socioeconomic status). These consequences do not arise only from the disease as such, but also from governments' reactions to the outbreak. However, it is hard to quantify them as convincingly as when COVID-19 death rates are presented.

In a larger sense, the question is whether drastic reductions of individual and economic freedoms will change the economic and political institutions and values in Western democracies. Another related question concerns the future relations between China and the West, given the fact that SARS-CoV-2 came from China after the initial cover-up followed by a rather quick recovery of Chinese economy. As China is on its way to become the world's largest national economy, the importance of the pandemic and its effects on the entire world cannot be understood without understanding modern China and its global role.

The quest for answers to these complex questions is beyond the scope of individual professions, be it epidemiology, sociology, economics, political science or psychology. One of us (Šonje) is an economist and the other (Kotarski) is a political scientist. Balancing between the safety of our "own" respective fields and the risk of venturing to other fields, where chances for making a mistake are much bigger, we decided we should take the risk and expand our analysis. The risk of making a mistake when broadening our perspective is lower than the risk of becoming irrelevant when focusing on economic and political details. A sudden asteroid impact is a great metaphor for what we have experienced in the past year and one cannot study an asteroid with a microscope.

In addition to our associates who made possible the Croatian-language edition of *Corona Economics*, we are particularly indebted to the European Liberal Forum and its Croatian partner, International Education Center Zagreb for the book's revised edition in English. The Center's director Goran Neralić had a crucial role in ensuring the preconditions for publishing of this book.

Velimir Šonje and Kristijan Kotarski  
Crikvenica and Zagreb, 28 February 2021

## INTRODUCTION TO A BRAVE NEW WORLD

The dynamics of the developments between late February 2020 and the present day, the emotions they have aroused and the importance of these developments for hundreds of millions of people can be compared with but one event in our collective memory – the fall of the Berlin Wall. This event marked the end of one totalitarianism and raised hopes that the dream of freedom would soon come true. Thirty years later, the COVID-19 pandemic marked the awakening and domination of fear and the demands for drastic reduction of all freedoms.

It is not the only difference between these two historical events. The key developments that led to the fall of the Berlin Wall and those that ensued afterwards took years. Unlike them, the twists in the pandemic followed each other with the frequency of weeks and months.

The fear of the virus – or, better, the panic caused by it – activated our basic emotions and instincts. Modern communication technologies added to the speed of their activation. This equally applies to those who perceived the disease caused by the virus as a direct threat to people's health and lives and to those who perceived it as a long-term threat to democracy, economy and jobs (thus also threatening people's health and lives in the long run). Sudden attacks of fear and stress affected our understanding of what was really going on, hindering productive communication between the former and the latter groups.

Decision-makers were relying on the authority of experts. While there was nothing wrong with it as such, one should keep in mind that no expert in their field can replace the wide range of the political considerations that take into account all the social consequences of public-health and political decisions.

The outbreak of SARS-CoV-2 virus and the reaction to COVID-19 disease had their positive aspects, too. They triggered innovation and research efforts aiming at better understanding of the related threats and better coping with them. As early as in April 2020, all those interested could follow the daily updates on the virus's characteristics, threats and ways of transmission, the outbreak dynamics in other countries and the countries' political decisions intended to contain the pandemic. The countries began to compare with each

other. A pandemic paradox happened: the expansion of the virus – which at first caused sealing of state borders and separated people – brought people and governments together in their efforts to understand the expansion and contain the pandemic. The first coronavirus vaccines were developed before the first year of the pandemic was out – faster than ever before in history. This is why the pandemic is not only a reminder of the fact that societies can easily descend into conflicts and authoritarianism. It is also a reminder of humanity’s creativity and innovation potentials when faced with major challenges.

Although the first wave of the pandemic was very strong in some European countries (Italy, Spain, Belgium, United Kingdom) and its consequences in some regions were much more serious than in earlier respiratory disease seasons – thus confirming it wasn’t “just a common flu” – the fact that, despite the relaxed measures, the virus temporarily retreated in the warmer months of 2020 was an opportunity for a break. A short break, though. The autumn of 2020 saw the arrival of the second wave, almost everywhere more lethal than the first one. This is why the news about the first vaccine approvals in December 2020 was welcomed with huge relief and with optimism in the stock market. However, when we became aware of the objective limitations of the production and distribution of the vaccine and of the related conflicts of interest, disappointment and continued lockdown followed at an even faster rate.

Politicians had to make decisions under uncertainty, which reduced their capacity for communicating the reasons for the measures and their duration in a credible way. People could not understand why in some countries shops with non-essential goods were open and restaurants and gyms were closed. And very soon after the outbreak it became clear that the economic crisis of 2020 would be deeper than the one of 2008/2009, which was the deepest crisis after World War II. Governments had to do something to mitigate the pandemic’s negative impact on jobs and incomes, particularly in the activities that had to be shut.

## LOCKDOWN: PROS AND CONS

The public split bitterly over the issue. Each opposing side advocated a widely accepted but very simplified narratives. One narrative assumed that it was an extremely great threat and that as much as one percent of the infected would die; it proposed a radical lockdown as the only possible response to such a



threat. It also hypothesized that such a radical lockdown would reduce economic and other social losses because it would be the fastest way of containing the virus and restoring the normal life. This viewpoint was inspired by the Wuhan experience of the Chinese.

The opposite narrative assumed that it was but a slightly more serious respiratory disease that would be over once a sufficient number of people have recovered from it. It proposed that COVID-19 could not justify the social losses that a radical lockdown would cause.

The advocates of radical measures relied on two arguments. First, we know too little about the virus – it could really be very dangerous. Second, the disease was successfully contained in China after a radical lockdown had been introduced on 23 January 2020. However, the polemics never assessed the size of the social losses of such a strategy. They never discussed whether the Chinese approach was possible in democratic countries – in other words, what would be the social “cost” of such an approach, given that the Chinese lockdown was based on the instruments typical of repressive regimes: full-scale suspension of the so-called non-essential activities, forcing people to stay at home and using electronic surveillance to keep track of them, and threatening the violators with long-term imprisonment. The fact is that, before the pandemic, banning movement not just between countries but also between regions, towns and even districts of big cities on such a massive scale had never been considered by Western democracies except during war times. Nevertheless, some democratic countries soon accepted such a model of struggle against the pandemic, particularly during the first wave when panic broke out. Others rejected it from the very beginning (Sweden). Most governments experimented with solutions between the two extremes, the solutions that included measures ranging from a radical lockdown to the relaxed measures that, particularly in summer 2020, resembled the normal pre-pandemic life.

Mistakes occurred in the above described conditions. The virus took some countries by surprise when it spread fast, causing a substantial increase in the death rates and launching fear campaigns. But it was not clear how could firearms in the streets, police sirens in parks, curfews and stigmatization of the people who wanted to exercise their freedom of movement – all witnessed at the outset of the pandemic – contribute to containing the outbreak. Some moves of the authorities invoked the memories of the totalitarian past.

## MORAL BLACKMAIL: THE CROATIAN CASE

The speed and strength with which the profound divisions among experts and general public spread through main communication channels of the new digital world were intimidating. Attempts to question the measures or require their relaxation were labeled irresponsible and unsolidary in a benign version and fascist (due to alleged lack of concern for the elderly and the vulnerable) in a malignant version. Most of the accusations during the first wave had Sweden as their target because, from the very beginning, that country had kept rejecting the measures that even slightly reminded of the Chinese lockdown. On the other side, there were salvos of accusations concerning neglect of children's education (particularly of the poorest ones) and shutting down parts of the health care system.

The introduction and implementation of the measures saw various twists. The Croatian case is exemplary here. At the press conference on 26 February 2020, after the first COVID-19 cases in Croatia had been confirmed, the minister of health claimed that the disease was not particularly serious: "It can be compared with a common flu," he said (*Slobodna Dalmacija*, 2020). However, after the disastrous developments in Northern Italy, where there were two to three times more deaths (mostly of elderly people) in March and early April than in the same period in 2019, almost all EU member states, including Croatia, decided to introduce some sort of a lockdown.

The key date was 9 March 2020, when the number of the COVID-19 deaths in Italy soared from 36 to 133. The Conte government opted for a lockdown – too late, according to many. The second key date was 16 March, when the daily number of casualties soared from 173 to 380. The information was also relevant for Croatia, because this was when Croatian government decided to introduce a local version of the "Chinese approach".

Introducing it was easy: media were reporting on the chaos in Lombard hospitals on a daily basis; besides, Northern Italy is close to Croatia and the first COVID-19 case recorded in Croatia was that of a football fan who had returned from a football match in Milan. Soon the virus spread in the hospitals in neighboring Slovenia. The fear became tangible: the threat was knocking on Southeastern Europe's door.

By the way it was introduced, the initial lockdown reminded of the times long gone. Croatia was no exception in this regard. A fear campaign – mostly spontaneous – took place in March 2020. It relied on three levers. The first one was the connivance of the editors of most media outlets to accept fear and lockdown in the name of emergency and humanity, without questioning the restrictive measures. The second one was the moral blackmail that could be summarized as “life or profit”. The third lever was the indiscriminate trust in the experts (not necessarily epidemiologists) who had allegedly offered solutions and all the government had to do was “listen to them”. The joint action of these levers led to previously unimaginable situations.

At the outset of the pandemic, the citizens who would go out for a walk in a park or by the lakeshore (while keeping physical distance) were accused by mainstream media of being irresponsible and posing danger to others, although there was no evidence for it. At the same time, the measures that could even then be reasonably expected to help slow the spread of the infection, such as wearing face masks, were not introduced. The public had problems understanding the (in)consistency of the measures.

The reactions of the government and government-controlled media such as the national television indicated that the initial idea had been to keep the citizens locked in their homes, following the Chinese example. The Croatian prime minister confirmed this in his 14 April interview to the Croatian national television. Thus, denunciation and stigmatization of the allegedly irresponsible individuals helped spread fear, additionally intensified by the major earthquake that hit Zagreb on 22 March 2020. Movement between counties was then banned. It was rather sad watching a report from the city of Split aired on the prime-time news on the national television at that time: A police officer with a gun holstered on his hip approached an elderly woman who was sitting on a bench with no one around her and told her to go home. The speaker’s comment left no doubt about who was right (the police officer) and who was wrong (the “irresponsible citizen”).

The leading media were full of various versions of that story. In an article published in *Večernji list* daily on 14 April 2020, entitled *The Elderly and the Sick Will Not Be Sacrificed in Croatia*, the former dean of the Zagreb School of Medicine said: “I truly hope that, should this pandemic endure, the young, the healthy and the business community will not suggest that the elderly and the sick be sacrificed for the sake of profit.” In the introductory part of the text, any

questioning of the official doctrine was even more directly linked with fascism: “The coronavirus pandemic revealed the Aryan tendencies of some young and healthy people who would sacrifice the elderly ones and those with chronic diseases for the sake of the economy, so that they could go on with their lives”. (Jurasić, 2020).

There were speculations that the dictatorships of the Chinese type were superior to the inherently weak liberal democracies when it comes to facing such a pandemic. In the introduction to the article *Pandemic Exposes Weaknesses of Western Democracy*, published in *Večernji list* on 8 April, its author says: “Many think that the pandemic has exposed numerous weaknesses of the systems of Western democracy and economy which (so it seems), while having had hard time holding out so far, have now become unviable”. (Vitas, 2020).

The said articles in the major media can be subsumed under the generic title “the end of the world as we know it”. The expression “new normal” has been accepted as a *fait accompli*. Saving human lives from COVID-19 was considered good enough an excuse for everything that had been done, including the use of disproportionate force that could affect the fledgling Croatian democracy that came into being only three decades before the coronavirus pandemic.

A lot of what happened and what was publicly said and written at the very outset can be understood as an inevitable consequence of rational fear. However, it is puzzling how little was said about the political and public health context in the first country hit by the pandemic – China. Perhaps Chinese authorities had no alternative to introducing a radical lockdown in Wuhan? The weak or non-existent primary health care and lack of public health system capacities in a country where health spending as percentage of GDP is a great deal smaller than that in the OECD countries made Chinese decisions on fighting the contagion straightforward. The legal framework which severely restricts individual freedoms and allows IT surveillance of citizens was conducive to it. Lack of broader and more critical views in the West of the Chinese political and economic context could be associated with the perception of China’s power. It is about the general view that modern China is much stronger and better organised than it really is. The same false perception plays the role in contemplating China’s role as the global engine of growth in the post-pandemic period due to its relatively fast economic recovery in 2020/21. Therefore, depicting China’s internal socio-economic imbalances is important both for understanding the rapid spread of the radical lockdown idea and for overestimating China’s role in the

global recovery after the pandemic. This is why an extensive discussion about China's role in the modern world and the relations between autocracies and democracies takes up the entire second part of the book. Without this perspective, broader understanding of pandemic historical context would be hindered.

The most disturbing thing in Croatia – and not just in Croatia – was the institutional organization of the system for the struggle against the pandemic. The Croatian government formed a special body – the National Civil Protection Authority (NCPA), consisting of 27 members including seven members of the police force headed by deputy prime minister and minister of interior. This body is in charge for all relevant decisions that the government or parliament would normally make: banning movement outside the area of residence, banning certain economic activities, introducing restrictive measures and other decisions regulating in detail all human interactions. As regards communication, the NCPA's principal function has been to convince the public that all the decisions have been approved by the famed “experts”.

If a chance traveler not familiar with the local circumstances visited Croatia at that moment, he might conclude that martial law had been declared. The “fight against an invisible enemy” was the belligerent metaphor of the day. No one questioned the fact that the delegation of authority from the government to the NCPA would make sense if the country was at war and if both the government and the parliament were prevented from convening regularly without risk, but in reality, the government and parliament had functioned without obstruction at all times. The fact that the Croatian body authorized for such decisions is called *stožer* (which also means the “army supreme command” in Croatian language) can be seen as yet another hint at martial law. Most people were so terrified that they unquestioningly accepted the above described political and communication framework.

It would be wrong to conclude that these developments and the prevailing social atmosphere had to do with the totalitarian past from which such popular backing of authoritarian solutions had arisen. True, in spring 2020, curfews were declared in Serbia and Bosnia-Herzegovina and the Hungarian parliament gave broader powers to the authoritarian prime minister Viktor Orbán. This seemingly implies that there is an inherent tendency toward authoritarian solutions in Southeastern Europe. However, the TV news from France, Italy and many other countries with long democratic traditions also included the scenes of police driving people away from parks. Later on, many democratic

countries would have no problem introducing measures even more restrictive than the ones in effect in Croatia in early spring 2020.

#### FEAR SUBSIDING AT THE END OF 2020

The initial fear was partly rational. Very little was known about the virus. It could have been much more dangerous than it turned out to be. This is why, at the outset of the pandemic, many governments had wide democratic support for the introduction of restrictive measures. It was not perceived as the end of democracy but, at least to an extent, as a manifestation of it. This is why not only the countries with totalitarian past have experienced draconic restrictions of freedoms during this pandemic.

After a brief relaxation in summer of 2020, the restrictive measures were back in autumn. The differences in the stringency of anti-COVID-19 measures between the countries during the second wave were greater than in spring 2020. This was because we had learned more about the virus and because panic had worn off. Also, some initial mistakes were not repeated anymore. The atmosphere became softer, more tolerant. The Croatian government representatives quit mentioning the Chinese approach to the pandemic containment as a role model. The decision to shut the schools was made at the peak of the second wave but it was tough and the government made it reluctantly and step by step, obviously hoping to avoid such a solution. The scenes of police officers ordering elderly ladies walking in parks to go home were not part of TV news anymore. This is why comparing the pandemic with the “five horsemen of the apocalypse” works only for the developments in spring 2020 and not for those at the end of that year, when the atmosphere changed.

#### THE FIVE HORSEMEN OF THE APOCALYPSE

The “five horsemen of the apocalypse” is a metaphor for the five bad ideas that surfaced in society like Genie from the bottle at the pandemic’s outset. They started spreading like corrosion, attracting growing numbers of supporters and advocates. These are: (a) “helicopter money” – the idea that the economic problems in the times of threats can be solved with distribution of fresh money

by the state; (b) “discredited European Union” – the idea that we are witnessing the end of the multinational framework of the international cooperation and exchange, which particularly refers to the European Union, allegedly discredited for failing to offer a common response to the crisis and help its most threatened member states; (c) “self-sufficiency” – the idea that the economic paradigm of the global capitalism is now giving way to reestablishment of national development frameworks, which allegedly represents a new opportunity, particularly for agriculture; (d) “nanny state” – the idea that reestablishment of the nation state as a political framework for the efforts to contain the virus will reincarnate socialism or a more robust capitalism – political or state capitalism – as an institutional framework for the future economic and social development; and (e) “suspension of democracy” – the idea that China’s success in the fight against coronavirus shows that too much individualism and excessive reliance on the liberal model of civil control of government can threaten the community’s survival during the pandemic, which is why new models of social organizations should be considered, ensuring firm control and coordination from the center and including collecting and processing of large quantities of citizens’ personal data. These five ideas are strongly interconnected; together, they constitute an entire world-view – a perception of humanity and of a different future of Europe and the Western civilization. They were articulated by some of the intellectual and political elites and disseminated by media in the specific Croatian context in the times of the pandemic. However, their local Croatian touch does not mean that they only have local relevance. In varying degrees, these ideas have been discussed throughout Europe during the pandemic. This is why the developments such as stigmatizing and controlling people who are free and who pose a threat to no one should be perceived in the context of the change of dominant ideas provoked by the fear of the virus, regardless of the customs, culture or political past of individual countries.

## SOLIDARITY, FEAR AND EXPANDED VIEWS

Fear has the central role in this story. It is more important than the historical legacy and the sense of solidarity. The true sense of universal solidarity could not have provoked excessive use of government compulsion, because the principle of avoiding to hurt others is embedded in the DNA of the principle



of solidarity. Universal solidarity always questions itself; fear doesn't. Fear is aggressive; it explodes and conquers. And fear is particularly successful when our knowledge of the danger in question is deficient.

As knowledge is never absolute, even what little knowledge we have can be repressed by fear in exceptional situations. This is exactly what happened in the case of the coronavirus pandemic. Fear has narrowed people's views and ruled out numerous open questions that should have been kept in mind since the outset of the pandemic in order to ensure rational collective decisions.

What open questions? Table 1 shows the taxonomy of the large-scale social problems that emerged with the pandemic. While incomplete, the list illustrates the extent of the problems the world is facing. The first thing to pay attention to is the general difference between the short-term (visible) and long-term (less visible and invisible) problems. The visible short-term problems always dominate over the long-term ones, particularly if they are easier to quantify. For example, shutting down schools will have such long-term consequences as fewer expected life opportunities, lower wages and even a lower residual life expectancy for children (Christakis, 2020). But this danger does not sound as convincing as the numbers of immediate COVID-19 deaths. The same goes for the long-term consequences arising from poorer prevention and treatment of other diseases due to the restrictions introduced to health care systems and fear. For example, it is estimated that, in the first half of 2020 in Croatia, approximately 3,300 fewer carcinomas were discovered – and between 30 and 69 percent less of them were surgically removed – than in 2019 (Novi list, 2020).

One additional problem is the structure of the dreaded reference figures – COVID-19 death rate and COVID-19 comorbidity death rate. Differences and mistakes are always found in the medical protocols and practices in determining causes of death (Ioannidis, 2020). Although systematized and accurate information about the protocols used by individual countries is not available, it is known that approximations are used in practice. For example, as far back as on 4 March 2020, American CDC (2020a) issued guidelines with the following formulation: "COVID-19 should be reported on the death certificate for all decedents where the disease caused or is assumed to have caused or contributed to death." We, the laymen may not know the exact meaning of the terms "assumed to have caused" and "contributed to death" in medical profession, but we do know that elderly people and those with severe diseases are exposed not only to a higher risk of SARS-CoV-2-related complications, but also to a



higher number of “contributors to death” – the so-called comorbidities. This probably makes it hard to identify the key contributor, while relativizing the assumptions about death and being aware that they are based on physicians’ experience (Ioannidis, 2020).

*Table 1. Taxonomy of key problems*

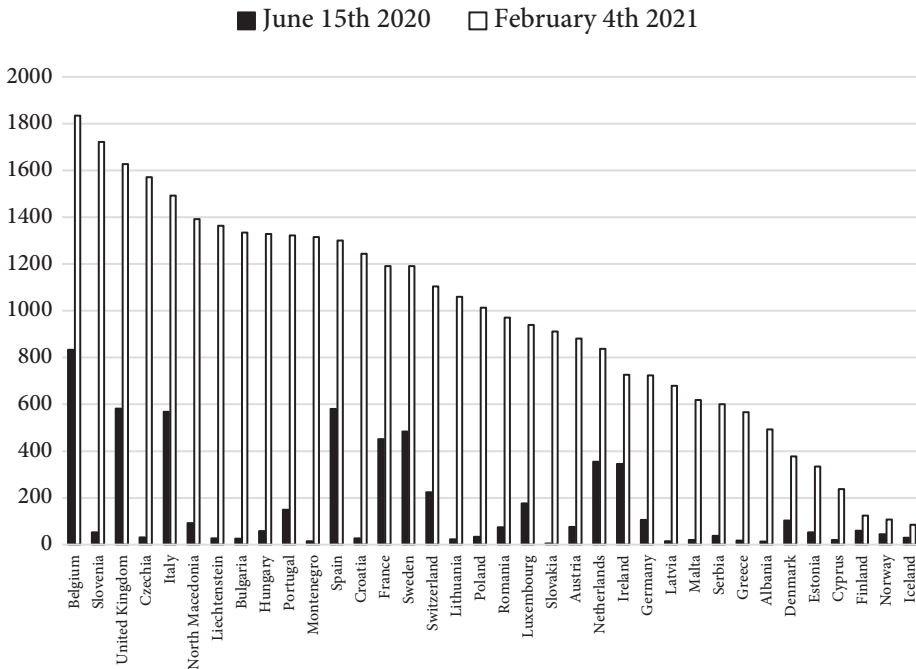
| Short-term (visible) problems   | Long-term (less visible or invisible) problems   |
|---|--|
| Infections – hospital admissions – COVID-19 deaths and COVID-19 comorbidity deaths  | Long-term consequences of COVID-19   |
| Poorer prevention and treatment of other diseases                                   | Long-term consequences of poorer prevention and treatment of other diseases                          |
| Unemployment and lower wages  | Long-term consequences of unemployment and lower wages   |
| Children do not go to school or receive online education only                       | Long-term consequences such as fewer expected opportunities, lower wages and a lower life expectancy |
| Lower GDP and higher public debt  | Long-term consequences such as slower development and less funds for financing future public needs   |
| Totalitarian ideas and trends   | Long-term change in political relations and institutions   |
| Psychosocial problems such as domestic violence, depression and suicidal tendencies | Long-term consequences of permanent exposure to psychosocial problems                                |

On the other hand, in the places that were the focuses of infection during the first wave – such as Bergamo, Italy and New York, U.S. – there were claims that the official death rates had been underestimated because many elderly people had decided to die at home without even attempting to go to hospital. For this reason, official death rates could be both underestimations and overestimations. Establishing the exact figures will require lengthy research. More time will pass before scientists manage to identify positively the social losses caused by the pandemic and by the reactions to it. Still more time will pass until the causes of these losses are identified.

## THE NUMBERS

The trends of COVID-19 death rates and COVID-19 comorbidity death rates in European countries illustrate the complexity of reaching conclusions on the pandemic and reactions to it. Figure 1 shows the number of deaths per one million inhabitants at the end of the first wave (15 June 2020) and after the peak of the second wave (4 February 2021). The countries are shown from left to right as per their respective COVID-19 and COVID-19 comorbidity relative death rates. The difference between the two columns shows the gravity of the consequences of the second wave compared to those of the first wave.

*Figure 1 COVID-19 official death rates per million  
in Europe: the first and the second wave*



Source: ourworldindata.org.

Eight countries of Western Europe (Belgium, United Kingdom, Italy, Spain, France, Sweden, Netherlands, Ireland) were hit hard in the first wave, when most of Scandinavia, Central Europe, Eastern Europe and Southeastern Eu-

rope faced much milder consequences. Eight hypothetical explanations of the differences between these countries were offered at the time: (1) The period between the outbreak in Northern Italy and the one in Eastern and North-eastern Europe was long enough to enable most of the countries there to prepare and introduce measures on time; (2) The countries with lower population densities fared better in the first wave due to slower expansion of the virus (this explanation is questionable, given the relatively solid results of the densely populated Germany); (3) The high tuberculosis vaccination (BCG) coverage of the population possibly indirectly reduces the risk of contracting COVID-19 (also an unproven hypothesis); (4) More precise protocols for filling out death certificates (for example, since the beginning of the pandemic, Belgium, the country worst hit by the virus, has included among COVID-19 deaths even the elderly people only suspected to have died of this disease (Lee, 2020)); (5) genetic factors; (6) cultural differences (due to higher confidence in their governments and better communication practice of their governments, citizens of some countries are more inclined to adhering to the restrictive measures); (7) climatic factors (sunnier and warmer weather slows down the virus expansion); (8) aging (median population age).

The second wave has shown that most of the explanations offered were wrong. Central and Eastern Europe were particularly hit by the virus (see the difference in the columns for the countries of this region in Figure 1). In the second wave, Slovenia, Czech Republic, North Macedonia, Montenegro, Hungary, Croatia and Lithuania came to the top of the European list. United Kingdom and Belgium also stayed at the top with more than 1,000 deaths per one million people by February 2021.

The expansion of the virus in autumn 2020 and in winter 2020/2021 leveled the health outcomes in Europe. The coefficient of the variation of COVID-19 death rates shown in Figure 1 dropped more than twofold, from 1.3 on 15 June 2020 to 0.5 on 4 February 2021. This notwithstanding, the large differences between the countries remained visible. The ten countries with the lowest COVID-19 mortality rate include Scandinavian countries (except Sweden) and South European countries. The ones with the highest mortality rate include most of the countries hit hardest in the first wave, as well as Central and Eastern European countries. Of the countries hit hardest at the outset, Sweden, Netherlands and Ireland experienced a relatively mild second wave.

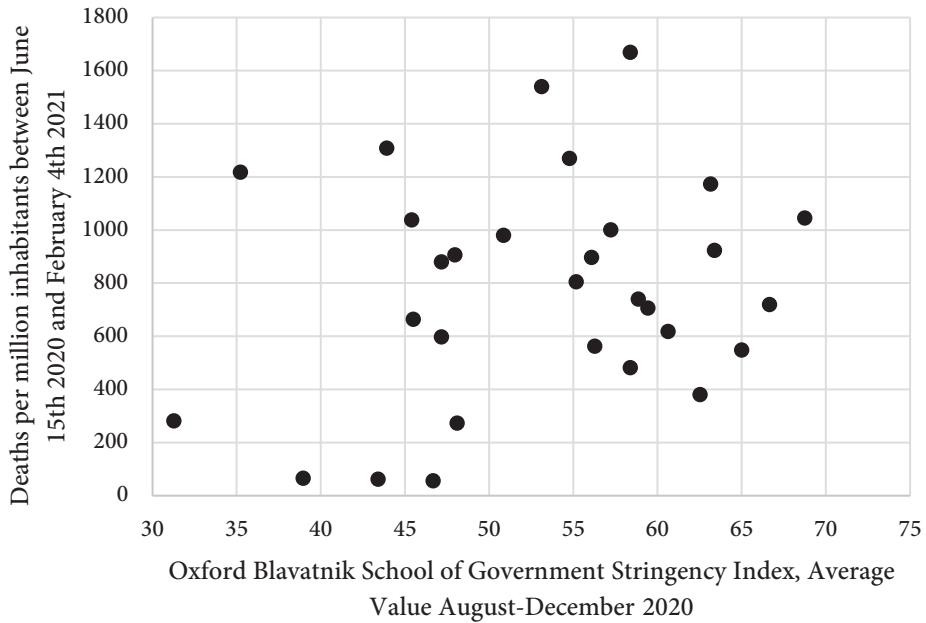
Seemingly, the above data suggest that the difference in outcomes could be explained with restrictive measures. However, it is very hard to describe and quantify the impact of measures in a way that would allow for reliable comparisons between the countries. For example, the medical treatments and protection systems introduced to nursing homes played an important role. At the very beginning of the pandemic, it turned out that COVID-19 death rates were highly dependent on the virus's spread in nursing homes and hospitals. When panic broke out in the first half of March 2020, these lines of defense were weak in all countries. Aggressive hospitalization of patients was mostly implemented at first, but that would change later, as we got further into the pandemic. Scientists have now accepted – at least as a hypothesis worth further research – that mortality could have been reduced with timely high-quality family-medicine treatments (McCullough et. al., 2021). Clearly, when it comes to medical treatments and protection of the vulnerable populations, differences in time and between countries do exist. However, comparing countries is not easy.

At any rate, the intellectual, political and media atmosphere at the very beginning of the pandemic could be compared with a situation where a torrent is about to break the levee and the discussion is focused on how to stop the torrent (the Chinese type of lockdown) instead of how to strengthen the weak points on the levee (the virus reaching the elderly). Of course, the concern about the levee and the concern about the torrent are not mutually exclusive, but when things take place at a dizzy rate, the focus is crucial. On the other hand, although the levees had been improved by the arrival of the second wave in autumn 2020, the death rates shot up almost everywhere – yet another piece of evidence that there are no simple solutions for the pandemic.

Figure 2, with European countries presented as dots, shows that the government measures' stringency indexes and outcomes (measured by deaths per one million inhabitants) cannot be unambiguously linked in such way that we could generally say: *the more stringent the measures – the lower the mortality*. In the cloud of the data in the figure, it is not possible to identify a statistically significant link that – if the measures were undisputedly effective – should be negative. The differences between the countries clearly require some other explanations; their positive identification will require years of research. But, as we will see below, some regularities can be detected in this cloud after all. There are countries like Ireland and Netherlands which, after the traumatic

first wave, managed to control their respective COVID-19 death rates in the second wave by introducing very stringent measures.

*Figure 2 Stringency of anti-SARS-CoV-2 measures and COVID-19 mortality rates in Europe – the second wave*



Note: Figure 2 shows fewer countries than Figure 1. Very small countries, except Iceland, are not included here in order to minimize the effect of random factors. The average value of the Oxford Stringency Index in the second wave can be seen on X-axis. If the stringency variable is defined as a change (tightening) of restrictive measures during the autumn wave, the conclusion that there is no link still remains.

Sources: ourworldindata.org and OxCGRT, 2021.

Figure 2 does not mean that the measures are not effective in general. Some measures are effective only sometimes – when they are credible, accepted, timely and well-designed. Not all measures are effective always and everywhere. What Figure 2 is really saying is that the devil is in the detail, because there are no simple solutions. A country strongly hit by the virus cannot just say: “Let’s do what Iceland or Germany have done and we’ll have the same outcome as they do.” There are too many things we still do not understand.

For want of a better insight and convincing recommendations, policymakers are doomed to the trial-and-error method combined with careful balancing of the ethical, economic, psychological and social effects of the pandemic

and of the consequences of fighting it. Various courses of action can be applied in such a complex situation with very diverse expected outcomes and some of them unintended because an inadequate reaction to a very dangerous virus could jeopardize the future economic growth, human lives and viability of liberal democracy, particularly if authoritarian societies turn out to be successful in fighting the same disease. On the other hand, an excessive reaction to a not so dangerous virus could also jeopardize the future economic growth and viability of liberal democracy, because the consequences of such a reaction would restrain economic growth, erode the trust in government and win recognition for authoritarian solutions.

#### HOW DANGEROUS THE VIRUS REALLY IS: THE EXCESS MORTALITY

Although chances are it will turn out that SARS-CoV-2 is not dangerous as it seemed at the beginning, the number and nature of the bad ideas that have emerged during the pandemic are terrifying. The concurrence and interaction of the ideas about helicopter money, discredited European Union, reestablished national self-sufficiency, nanny state and inherent weakness of liberal democracy in coping with major crises have a toxic potential. Before explaining these ideas in the text below, we should explain in more detail why we think that it will probably turn out that SARS-CoV-2 is not as dangerous as it was presented in the beginning of the pandemic.

In the beginning, most experts speculated that the share of deaths among the infected (infection fatality rate, IFR) could rise to 1%. When proportions are translated into absolute numbers, this meant that in Croatia – a country with a population of four million – between 10,000 and 20,000 people would die of COVID-19 in a single respiratory-disease season. One should keep in mind here that the actual number of cases is always substantially higher than the number of cases confirmed by tests. For example, if 50-60% of the population is infected (also one of the numbers speculated about in the beginning), we have a 5-6 per mille mortality rate (5,000-6,000 deaths per million in a single respiratory-disease season). We know now that the outcomes recorded by February 2021 (the total amount of the first and second waves – in reality, two

COVID-19 seasons, the first of which was shorter by half) were much lower than initially expected.

Two objections can be made about the above figures. First, the pandemic has still not been contained and the mortality rates are still going to rise. The answer to this is: At the time of completion of this book (early March 2021), it can realistically be expected that the spreading of the virus will slow down across Europe even before the vaccination coverage is completed. The approaching sunnier and warmer days will strengthen people's immunity and slow down the expansion of respiratory viruses. A possible third wave will probably be milder than the second wave experienced in the winter.

The second objection is that the mortality rate would be approx. six per mille if it wasn't for drastic restrictions; thus, the difference between the expectations (assessed for a situation without measures) and outcomes confirms the relevance of the initial expectations. The answer to this objection is that there is no doubt that the measures were needed. Indeed, there is general consent that some of them are efficient: keeping physical distance, maintaining hygiene, moistening and airing rooms in winter, banning mass gatherings. However, there is doubt about the Chinese approach – a radical lockdown based on the idea that the virus can be eradicated with drastic measures such as confining people to their homes, banning movement, economic activities and all gatherings and shutting down schools and institutions. In short, freezing everyday life. The ratio of social losses and benefits resulting from such measures is debatable and there is evidence of very negative social side effects (see the taxonomy of negative effects in Table 1). In other words, the virus would have to be much more dangerous (expanding faster and having a very high IFR) so that drastic lockdown measures could perhaps be justified. We will revisit this thesis throughout the book.

Most studies of various countries have shown that the IFR is much lower than 1%. They have also shown there are major differences between generations when it comes to IFR, as well as major differences between countries. The first large-scale meta-analysis of a limited data set carried out at the very beginning of the pandemic indicated that the average IFR was 0.68% (Meyerowitz-Katz and Merone, 2020). Subsequent studies yielded lower estimates (0.5% and below; SWPRS, 2021). The meta-analysis carried out by Levin et al. (2020) established that the IFR for those below the age of 55 was negligible; so did some other studies, which also identified risks on the level of the problems

we are successfully dealing with on a daily basis (Ioannidis et al., 2020). IFR grows with age: 0.4% for those around 55 years of age; 1.4% for those around 65 years of age; and up to 15% for those around 85 years of age. These figures are often confusing as debates about them are pervaded with fear because whoever allegedly relativizes them can face moral accusations of advocating a fascist treatment of the elderly. The only way to avoid this moral trap in a discussion is to invoke the results of some analysis of potential years of life lost, or some similar analysis trying to identify the persons who would probably have lived if they had not died of COVID-19.

It is a methodological thin ice. In October 2020, Harvard geneticist Stephen Elledge published a study indicating that COVID-19 had taken 2.5 million potential years of life to those who died of the disease in the U.S. The result attracted media attention. Elledge's large sample included 194,000 deaths in U.S.; the result of the division of the former figure by the latter is approx. 13 – the average number of potential years of life lost per person who died of COVID-19. However, Elledge's dramatic assessment was based on a methodological mistake. If a 65-year-old person died of COVID-19 or of COVID-19 comorbidity, Elledge applied the expected remaining years of life for men aged between 60 and 70 (let us suppose it is 18 years), thus calculating that the number of potential years of life lost for such person was 18. By adding these years of life lost for every deceased person (while making difference between men and women), he obtained a result of 2.5 million potential years of life lost for the entire population.

Being aware of the comorbidity problem, Elledge underlined that he had included the reduction of lifespan due to other diseases in his assessment of the remaining years of life, thus allegedly ensuring the accuracy of the assessment. However, hidden assumptions have crucial impact on the result, making it overrated. It is believed that persons who die of COVID-19 usually have other characteristics (e.g. other diseases, habits etc.) typical of the population mean of an age group. If this were the case, we could assume that the number of lost years for every COVID-19 victim would, on average, be equal to the remaining expected lifespan for that particular age group. However, COVID-19 deaths were not obtained by random sampling from the age group. These persons come from the segment of the age distribution where the expected remaining lifespan is much shorter than the mean value in the age group because of other diseases, bad habits, poor immunity or some other factor affecting life



expectancy. This is why almost complete information about a person's health is required for a statistical analysis to be carried out in order to assess the number of the remaining potential lifespan for the persons who died of COVID-19 or of COVID-19 comorbidity. The public debate on COVID-19 was ridden with similar speculations and errors.

As it is hard to have both high-quality data and a good methodology for analyzing a new phenomenon, we must rely on methodological shortcuts for now. Monitoring the excess mortality is one such shortcut. If we want to make a rough assessment of the number of COVID-19 patients who die – but otherwise would not die within a short period of time – we must observe the rapid rise of the total mortality above the long-term trend formed on the basis of the data obtained in previous years. Such analyses have shown that, in some countries, COVID-19 caused an exceptionally high excess mortality, recorded also during the winter seasons of respiratory diseases. COVID-19 indeed is a dangerous disease. One such database (Euromomo) shows that, in 2020, exceptionally high excess mortalities were recorded in Austria, Belgium, France, Hungary, Ireland, Italy, Netherlands, Portugal, Slovenia, Spain, Sweden, Switzerland and United Kingdom. The length of this list indicates how dangerous the disease is, despite the fact that no such rapid rise can be seen in some of the countries included in the weekly database (Cyprus, Denmark, Estonia, Finland, Germany, Greece, Luxembourg, Norway, Malta). Although the database does not include data on Croatia, we will present them here in order to illustrate the framework for discussing the crucial issue: is SARS-CoV-2 virus really so dangerous that saving lives can justify any measure, even a radical lockdown?

According to the preliminary data of the Croatian Bureau of Statistics, 56,677 deaths were recorded in 2020, which is 1,026 persons (1.8%) more than the preliminary data for the year with the highest mortality rate so far (2015). If the mortality rate is compared to the multiyear mean 2015 – 2019, the excess mortality was 3,145 persons (5.9%).<sup>1</sup> This indicates that COVID-19 indeed is a dangerous disease that has caused substantial excess mortality. There is no much doubt about it because no significant excess mortality was recorded in Croatia by October 2020. Mortality was concentrated in the final months of

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<sup>1</sup> The preliminary data is compared to the preliminary data from previous years to ensure methodological consistency.

2020, when the official COVID-19 deaths reached their maximum, coinciding with the peak of the second wave of the pandemic. However, this mortality is a few times lower than the one we would have if the initial prognoses based on an IFR close to 1% came true. Also, the decline of the pandemic in early 2021 and – for now – the absence of seasonal flu give hope that mortality loss will occur later in 2021. If this happens, it will mean the toll of the second wave of COVID-19 has included some of the lives of the people who would hardly survive several months into 2021.

The mortality trends and the occurrence of the negative effects of COVID-19 should be perceived in the context of fundamental aging of the population. Like in many other European countries, the oldest age groups in Croatia grow every year. This means that the population's average vulnerability to various diseases grows year by year, placing new challenges on the public health care system designed for different demographics. In terms of organization and flow of information, the public health care system is not flexible enough to respond to short-term stress and growing fluctuations of the demand for health services. In other words, the aging population not only leads to a linear growth of the health care service demand in proportion to aging, but also to growing fluctuations of the demand – occasional peaks grow much faster than the average demand caused by ageing.

#### THE PROBLEM REQUIRES A HOLISTIC VIEW

The pandemic episode could lead to a substantial revision of the analytical models used for making decisions in public health-care management. In the countries where such models are made, a model based on the concept of social wellbeing has been used in discussions. These models have tried to determine the optimal *sacrifice* of GDP in fighting a disease. For example, in the case of COVID-19, sacrifice is manifested as a decline in economic activity caused by the lockdown; this amount/decline and the expected remaining lifespan preserved by the lockdown are then evaluated in the context of opportunity cost – the neglected benefits of using these resources for dealing with other risks (like containing other diseases like carcinoma or cardiovascular diseases) or reducing traffic-related risks by building better roads (Wilkinson, 2020). For example, if a lockdown that leads to a drop of GDP of 6% preserves longer

expected remaining lifespan of people than investing the same amount in alternative public health programs would, then the lockdown “pays off”.

The accuracy of the results of such models is questionable (due to the enormous complexity of the problem to which a model is being applied), but the line of thought that such models stimulate is very useful. It reflects a comprehensive cost-benefit analysis of public policies and enables pondering their long-term and short-term consequences at the same time.

Such models are often criticized as being too “economistic”. However, it does not mean that they do not contain an ethical component, if only implicitly. They are merely a macro representation of the reality that physicians face in their practice when they have to decide whom to treat (given the limited medical resources). Such a decision can be based either on a seemingly neutral criterion (the first person to arrive gets the treatment) or on an explicit ethical criterion (the person with a longer expected remaining lifespan gets the treatment – e.g. a child, not an octogenarian). Ethical choice is always hard, but limited resources sometimes require it. It is important that those who make such choices are well-informed both on micro and macro level.

Since the beginning of the pandemic, economists have tried to integrate the epidemiological and economic variables into holistic models. For example, Bodenstein, Corsetti and Guerrieri (2020) divide economy in two sectors: the core sector (we can also call it the “infrastructural” sector) and the non-core one. They show that some of the measures, such as non-core-sector workers performing their tasks from home and social distancing, can enable normal functioning of the core sector, thus mitigating the short-term shock for the economy. Although this model is also very abstract, it relies on a line of thought more appropriate for the structure of modern society than the Chinese perfect-lockdown approach (which includes atomization and paralysis of society intended to eradicate the virus); society is a too complex an organization to be observed as an epidemiologically and socio-economically homogeneous space populated with atomized individuals.

In the text below we will not deal with public health care issues that much. We will also bypass the abovementioned economic models. The book deals with a broader subject – the comprehensive issue of the society’s response to the pandemic and its consequences. Although the five horsemen of the apocalypse – the five bad ideas that could transform the society as we know it (helicopter money, discredited European Union, self-sufficiency, nanny state and

inefficiency of liberal democracy) – are the primary focus of this book, we will only discuss them in its third part. Part one, defining the book's broad framework, is dedicated to the ideas and ideologies that have imposed themselves as a dominant interpretative framework of developments in the atmosphere of fear at the very beginning. It is very intriguing to answer the question how it is possible that the reaction model employed by a totalitarian society with poorly developed public health care was used as a role model by the Western democracies with much more developed health care systems and bigger capacities for pursuing public policies. To find the answer to this, one should understand modern China and its influence on the world – which is the subject of the book's part two. This sets the stage for part three, a story about the five horsemen of the apocalypse. The five bad ideas (helicopter money, discredited EU, self-sufficiency, nanny state and inefficiency of liberal democracy) were not clearly articulated in the atmosphere of panic at the outset of the pandemic. However, the Pandora's box was opened and these ideas poured out into the public space. While we cannot emphasize enough that the loss of every life is tragic, losing liberal democracy – the freedom, way of life and values that have ensured peace and prosperity in Europe for decades – would be a real tragedy. This fear is the prime motive for this book.

**PART 1**

**INFORMATION AND**

**IDEOLOGIES**



## F.E.A.R.

The coronavirus pandemic had serious media, political, economic, moral and other consequences. We could feel that at the very beginning of the pandemic. A very popular Croatian portal interviewed the first persons in Croatia infected with the coronavirus (they had contracted it at a football stadium in Milan). The headline was *Confession*. When COVID-19 is in question, there are no interviews. The media and the public assume the roles of the church and a priest, respectively, and the individual – “guilty” of bringing the virus – is expected to confess in this “church”.

When is it that reflecting fear through media can make sense? The consumers of media are prone to fear because of the typical human failure to adapt to risk and uncertainties. People usually lack a sense of odds; they have poor understanding of statistics and fear easily prevails over their reason. But fear can be rational if we lack information about what is really dangerous. So the question is, how can one tell rational (justified) fear from irrational (unjustified) one and how to assess the COVID-19 danger in this context?

### PUBLIC COMMUNICATION TECHNOLOGY AND THE ROLE OF EXPERTS

Information channels, politics and media are not impartial. The ideological and interest prisms bend the information disseminated by media. This is why media present information using the formats (headlines, subheadings, emphases) not primarily intended to inform but to attract attention or deepen a conflict, particularly if the subject is popular. Fears and conflicts are the best generators of attention. This is why public information is not enough to tell rational fear from irrational one – to tell dangerous situations we do not know well (when fear is rational) from the less dangerous ones (when information is available but is not collected and analyzed well and no correct conclusions are made on the basis of it).

Experts should help solve this problem with their public work. They are expected to rationalize fear in two ways: by conveying the information known by them to be reliable and by restraining from conveying the information not known by them to be such. Swimming against the stream is very useful when there is a good reason for it. The herd psychology can be defeated this way.

Very few scientists have adhered to these canons during the pandemic. It is hard to say has there really been so few of them or was it the selective approach of the media that has given us such an impression. It seems that a combination of mistakes on both the information supply-side (scientists' excessive confidence in their own models and views) and the information demand-side (media's preference for extreme views that attract attention), together with the inevitable effect of multiplication in an integrated digital world, played an important role in the phase of initial reactions to the COVID-19 pandemic.

#### “THE WORLD’S BIGGEST HEALTH THREAT”

On the global level, the most commented-on has been the model of the London Imperial College, whose public face – epidemiologist Neil Ferguson – was no help to the critical interpretation of the prognoses made by the team he had led. In March 2020, Ferguson issued a warning: “The world is facing the most serious health crisis in generations.” The graveness of this prediction gained additional importance when it was printed in a WHO publication (van Elsland and O’Hare, 2020). However, the past development of the pandemic far from confirms the author’s claim. Proclaiming COVID-19 the world’s biggest health threat in several generations is inappropriate if we know that every year 5.5 million children in the world die before reaching age of 5, that 9.6 million people die of cancer, and that one million die of HIV (84% of them below the age of 50). A total of 33 million (mostly young) people have died of HIV so far.

Of course, the above figures cannot be directly compared because different people suffer from different diseases in different parts of the world. However, presenting the figures the way Ferguson did illustrates the fact that the problem does not always depend on how information is processed on media’s information demand-side. The responsibility often lies on the information supply-side – in other words, on experts. Not only they themselves tend to exaggerate, but they often systematically conceal the limitations of their prognoses. And as



regards epidemiology, it was proven during earlier pandemics that epidemiological prognoses are inaccurate (Ioannidis, Cripps and Tanner, 2020). Also, there were many attempts to apply models on concrete cases that resulted in failure (Chin et. al., 2020).

Why do some scientists fail to be critical of their own models and conclusions? The reasons are varied: high ego, fear of losing influence or funding, subconscious subjective bias, excessive optimism and lack of critical filters when making prognoses. Also, it is possible that the epidemiologists, who took the Hippocratic oath as medical students, lose their objectivity in order to instigate fear. It is easy to understand the attitude that it is better to be excessively pessimistic than excessively optimistic because sounding alarm bells can influence people's behavior and save lives.

Whatever may be at work, bias can make prognoses swing both ways. At the outset of the pandemic in Croatia, a Croatian-born scientists based in Canada calculated the probability of the COVID-10 danger (N1, 2020). This calculation soon spread via social networks and mainstream media. The calculation said: There were 77,000 COVID-19 cases in Wuhan (approx. 0.7% of the city's population) and the mortality rate was approx. 2.5% among infected. If we multiply the first number (probability of infection) with the mortality rate, the result is the probability of dying of COVID-19, which is 0.0175%. This means that the chances of surviving the pandemic is 99.9825% ( $=100\% - 2.5\% \times 0.7\%$ ). Consequently, the scientist's conclusion was: "Have no fear".

In December 2020, the same scientist joined the group who signed the appeal for a radical lockdown, although by that time statistical data had indicated that Croatia had already seen the peak of the second wave of the pandemic. How did such a twist take place? Scientists themselves have two answers. The first one blames media ("I was misinterpreted") and the other one invokes a change of attitude as a scientific quality. The scientists with broader education often quote famous economist John Maynard Keynes, who once said: "When the facts change, I change my mind, what do you do, Sir?"

Let us go back to our Canada-based scientist at the outset of the pandemic, when his public appearances were reassuring. Too bad he failed to compare his probability calculation with the flu figures. For example, by 21 February 2020, approx. 29 million people had contracted seasonal flu in the United States, so the probability of contracting flu there was then much higher than the probability of contracting SARS-CoV-2 in Wuhan: it was 8.9% because the U.S. has

approx. 330 million inhabitants. However, the flu mortality rate was far below 1 per mille (= 16 000/29 000 000). When this quotient is multiplied by 8.9%, the resulting probability of dying of flu in the U.S. during the flu season of 2020 is 0.005%. This is as if we said that the total probability of surviving the seasonal flu in the U.S. (according to CDC data) were 99.995% (CDC, 2020b). And this figure is even more reassuring than the probability of surviving COVID-19, which allegedly was 99.9825%. Consequently, the “Have no fear” conclusion is questionable when compared with the “common flu”.

To the layman, the difference between 99.995% for flu and 99.9825% for COVID-19 may seem insignificant. Can such a small difference actually influence someone’s behavior? You can make your own comparison:

*Chances of surviving the flu epidemic  
vs. chances of surviving the COVID-19  
pandemic in the overall population  
(the February 2020 assessment):*

$$99.995\% > 99.983\%$$

#### DOES THE DIFFERENCE BETWEEN FLU AND COVID-19 JUSTIFY PANIC?

Let us help you. The number on the left means that 50 people in 1 million will die of flu. The number on the right means that 170 people in 1 million will die of COVID-19. Based on the data on 4 February 2021, our scientist gave a rather accurate COVID-19 mortality prediction for Finland, but he underestimated the COVID-19 mortality rate in Croatia 7.3 times because the mortality rate there was 1.22 per mille (or approx. 1,220 persons per 1 million) (Figure 1). This does not mean he should have panicked at the beginning of the pandemic (he tried to make amends for it after the peak of the second wave had already been over); this only means that his prognostic model was not well-adjusted for the country that was the object of his analysis.

Besides, predicting the overall survival or mortality rates does not mean much. By the time when the above prognosis was made at the outset of the pandemic, it had been known that the IFR was very different for various seg-

ments of the population, depending on their age. The probability of death generally depends on one's age a lot. This is why the scientist calculated the probability of death by age groups. The probability of survival is much higher in younger people – very close to 100%. Based on the official Wuhan data, this probability for the children of up to 10 years of age is 100% because no child in Wuhan died of SARS-CoV-2. Later experience of other countries confirmed this figure. On the other hand, according to CDC, as many as 105 children in the United States died of flu in the season of 2020 (CDC, 2020b). Consequently, although the probability of surviving seasonal flu is higher than the one of surviving COVID-19, shouldn't we be more concerned about the higher probability of children contracting seasonal flu and dying of it? If each of these 105 children who died could have lived another 70 years, this means more than 7,000 potential years of life lost. If you consider comparing the remaining potential lifespan to be morally acceptable, it is as if 28,000 very old people who would otherwise live three more months died of COVID-19.

## ETHICS AND LIFE

The above example shows that the conclusions based on probabilities depend on the value judgments hidden behind numbers. Basically, everything is an ethical issue when life is concerned. The difference between two overall probabilities (for COVID-19 and for seasonal flu) can be big enough to cause panic in some. In others, who value the lives of children more than anything else, seasonal flu and some other diseases are supposed to scare them more than COVID-19 virus.

The morality of expected remaining lifespan can be juxtaposed against the morality of the absolute value of life (every life is equally valuable). Meet Marko, a mathematician. Early in March, he and his son Ivor went to grandma (80+), filled her pantry and fridge with foodstuffs, seated her at the table and explained to her that she should not leave her house in the days to come. Ivor will be bringing supplies from the store, but with much caution. When they visit her, they will leave their shoes outside, wash their hands with a disinfectant and avoid touching her. Also, they will visit her less frequently than before. All this because they know that the probability of dying of COVID-19 grows with old age.

Marko is trained for solving statistical problems. He knows about the official Wuhan mortality rate figures. He read that the actual number of the infected was much higher than the official figures, which means that the mortality rates are also much lower than the official ones. So, should he be less concerned? No, because he is familiar with the concepts of probability space, exponential functions and networks. There are two things that make him stay on his guard. First, if the virus has indeed spread much more than the official figures suggest and if it is still spreading fast, then the probability that he or his son are asymptomatic or presymptomatic virus carriers (they have contracted the virus but are not actually ill) is also growing rapidly. Still, they can give grandma the bug. This is why they are very cautious for a reason.

Marko's mother is very upset while listening to her son. Her loneliness has been her nightmare for 30 years. Watching his mother frown on the other side of the table while he and Ivor are persuading her to be rational and minimize the risk, Marko is wondering if he has gone too far with safety measures. It is quite possible that, like politicians, he has unintentionally increased one risk by reducing the other. In grandma's case, it is the risk of stress caused by her loneliness.

This case shows that even highly educated Marko has problems translating general information, numbers and percentages into concrete decisions. The pandemic-related philosophizing of know-it-alls that has flooded the media and social networks seems to bear no comparison with the enormous problem they call COVID-19 – the world's biggest health threat in generations. Ivor read somewhere that these were the words of a well-known English epidemiologist. Ivor thinks that every human life is equally important. He supports the lockdown announced by politicians for the next week. All people should be protected, including his grandma.

Marko is skeptical. He explains to Ivor that he should not believe everything he reads or hears. After all, how can one believe an epidemiologist who claims that the greatest plague of all time is coming when 33 million people have died of HIV alone? All right, HIV is not airborne. It can be controlled by responsible behavior. But still, perhaps the same holds for COVID-19; knowing a thing or two about respiratory diseases and the developments in Wuhan, there is something Marko does not understand. It is possible that there is politics or some ideology behind it all again? One way or another, he will be very careful. He must protect his mother.

## IDEOLOGY AND LIFE

Ideology is not necessarily a bad thing. Sometimes it enables seeing the big picture and elevates discussion. This is an optimistic view of the role of ideology. However, discussion is usually affected when ideological prisms are imposed. The latter happens if loosely defined ideological terms are used in a discussion and if such a discussion occupies the space that would otherwise be occupied by facts and the carefully prepared arguments.

Although he has not taken a keen interest in these subjects, Marko has learned enough to realize that economists, politicians and various commentators have been pinning ideological labels indiscriminately. He would make them all do some math for a while. There are no labels in math. This way, everyone is neoliberal or communist or libertarian or conservative, even when pandemic is concerned. In Marko's opinion, neither those who label others nor those who are being labeled know a lot about it. This very morning, for instance, he read the following headline on a portal: *Stubborn facts: When pandemic begins, there will be no more libertarians*. What does that mean?

The author of the message assumed that there were two opposing ideas – or social activity practices – confronting each other in economic issues and spilling over to other social sectors such as health care and education. The liberal or libertarian idea is allegedly based on the concept of a spontaneous order of the world and posits that free individuals should regulate their own relations. In this case, it is the principle of the survival of the fittest that allegedly determines the outcomes. In this clearly dehumanized vision of the world, there is no place for solidarity. Marko heard about the phrase from the headline before; he also remembered that he had once asked his two friends – one with a degree in economics and one in philosophy – if that was really the definition of liberalism. “Did they teach you at college that solidarity – a value allegedly usurped by leftist ideologies – is really in short supply in liberalism?” They gave him two different answers and he did not bother thinking about it anymore.

Dilettante ideologists, mostly on the left, have been exhausting Croatia intellectually and politically for about seventy years. As the ideas of such ideologists have always been a source of conflicts and not debates, the public has not acquired the skills needed for productive dialogues about ideas. Even so-called

intellectual public only knows how to label people, side with one tribe against another and wage trench warfare for bad and inarticulate ideas.

## THE ROLE OF AUTHORITY

It is not a problem when a journalist or editor of a major media company uses ideology. A problem arises when vague ideological perspectives are imposed by the country's most influential authorities. When the pandemic spread, a number of people with PhD in medicine showed particular interest in media attention and usurped the position of leading authorities in the public, regardless of their respective fields of expertise. Marko noticed among them two microbiologists, one geneticist, one pulmonologist and only one public health expert. Marko was puzzled but did not pay much attention to it until one of them – an expatriate scientist who had suddenly returned to Croatia – started appearing in media and using those same confusing terms that Marko had failed to learn more about from his friends.

Justifying his use of an ideological perspective with the need for a “clear contrast”, the acclaimed scientist described in his Facebook status two possible virus containment strategies. He labeled one of them “extremely neoliberal”, as it allows free spread of the virus. In such case, calculated the scientist, a total of approx. 70,000 people would die in Croatia in 2020 (compared to the long-term average of slightly above 50,000 per annum). It is much more than 60,000 in an alternative scenario depicted by the famed scientist. Although he did not elaborate on this particularly, the scientist probably meant what he had labeled a “leftist and centrally planned” strategy – for example, a two-month-long general lockdown like in China. In an ideal case – wrote the former expatriate – this strategy would lead to a lower number of deaths, but the economic consequences would be harsh (Rudan, 2020a). Marko realized it would mean between 60,000 and 70,000 deaths in the pandemic year 2020 even if the “leftist and centrally planned strategy” were applied. He remembered this prediction again when the mortality rate for 2020 was published in January 2021: the total number of deaths in Croatia for 2020 was somewhat below 57,000.

Where does the widely accepted idea that “Darwinist” extremism could be linked to the term “liberal” (if only “neoliberal”) come from? When facing a pandemic, this type of extremism supposedly justifies failure to act: free spread

of the virus is allowed so that collective immunity could be achieved. However, a liberal does not suffer from split personality disorder when protecting his own family, just like Marko wants to protect his mother. A liberal will also not hesitate to take action when members of the community not related to him or connected with him in any other way are to be protected. On the contrary, a liberal does not consider family ties as a criterion of humanity, because liberalism is an ideology that puts human life before everything else. This is why liberalism is incompatible with the idea of conscious and planned sacrificing of people.

It is precisely Nazism that contains the idea of planned sacrificing of people – specifically, of certain “types” of people, be it Jews, Roma, Slavs or the elderly. This is why linking the term “liberal” with pandemic requires deeper consideration of the ties and difficulties in translating the liberal principle into practical morality and policy. Throughout history, liberalism suffered a great deal precisely because dilettante ideologists had claimed that it relied on abstract spontaneity and ideological stereotype of “Darwinism”.

The problems our scientist was facing were not only of an ideological nature. Predictions were also a problem. The only thing one could make out from his number of expected deaths in Croatia in 2020 was the difference of 10,000 (= 70,000 - 60,000) between “extremely neoliberal” and alleged “leftist planning” approach. Scientist added to the latter a few thousands of people who would die as a result of economic recession. Marko wondered how could economic recession in Croatia, a country with a population of four million, kill a few thousand people. Once again, he asked his friend economist for an explanation. The friend told him that, while some research had established a connection between unemployment and mortality, others had failed to identify it, let alone determine a cause-and-effect relationship in which unemployment inevitably causes death in a number of cases. In his 2015 research, Ruhm even managed to identify a reverse relationship (unemployment improves health because people have more time for themselves). Ionides et al. established the same (Ruhm, 2015; Ionides et al., 2013). Marko’s friend did not mention these studies as ever-applicable evidence. He merely suggested that they implied reasonable doubt and functioned as a warning that one should be very careful when linking unemployment and recession with mortality.

Marko knew that both man and society were made of fine, complex fabric. In his own words, the relations in society are not linear; they spread via a grid.



This is why it is possible that an effect of a higher order conceals an important link, not visible at first sight. Marko's family is that fifth digit from the left in the balance of mortality predictions where 10,000 (20% of average annual mortality in Croatia) is a measurement error in irresponsible forecasts. This is why Marko knew no one could help him – neither the government nor science nor government measures. He himself had to protect his mother. And that's the way it was. His mother lived to see the end of the first pandemic year.

Let us return to our Canada-based scientist from the beginning of this story – the one who, instead of overestimating it, underestimated sevenfold the number of COVID-19 deaths in 2020, only to change sides in December 2020 and start demanding a full-scale lockdown after the peak of the second wave of the pandemic had already passed. The scientist's prediction was based on the data from Wuhan, where drastic isolation measures had been introduced. Perhaps somewhere else, where isolation measures were different, the numbers would also be different (worse)? If the answer is yes, it could explain the initial mistake in the prediction, although the scientist himself failed to underline these reservations. Marko knew a thing or two about prognostic models and statistics – certainly enough to sense ignorance behind it. And then, one March morning, his suspicions were confirmed.

He occasionally read *The Atlantic*. It was a website with high-quality informative texts. Mark Lipschitz (2020), a Harvard epidemiologist, told *The Atlantic* journalist we couldn't come up with any reliable death rates before serological tests were carried out on random samples of the overall population. The Harvard professor was even willing to "bet" that such tests would reveal that there were much more people infected with the virus than it was officially established. The reason is the fact that some people (14% of them in the case of common flu) never develop any symptoms, and if they do, they are mild; most of them never go to the doctor unless they develop unbearable complications. Also, at the outset of every epidemic, testing is always inadequate and the tests themselves take time to improve. If Lipschitz was right, the actual COVID-19 death rate could be much lower than the one recorded in Wuhan and the actual spread of the virus could be much wider than the one indicated by testing, although World Health Organization has the official Chinese data at its disposal. Very confusing, concluded Marko.

Marko knew that, for all those who had developed a temperature of 38°C and went to see the doctor at the outset of the pandemic, chances were they



would undergo a routine checkup with a spatula and stethoscope, with no tests whatsoever. The doctor would perhaps prescribe Sumamed, a wide-range antibiotic (azithromycin) and the best-known product of Pliva, a Croatian pharmaceutical company. It would win fame during the pandemic when, in April 2020, the story went that it could cure COVID-19 when combined with hydroxychloroquine. Later studies ruled it out, but some recent ones have again shown that this combination can be efficient if applied at the early stage of the disease (McCullough, 2021). All this led Marko to believe that, back in March, millions around the world had been staying at home, drinking tea with honey and lemon and waiting for the “cold” to pass. Who knows what virus did they have. Could it be that the awful cough and temperature he had had in January could have been COVID-19?

And finally, there are always Type I and Type II mistakes – a possibility that a certain number of deaths has not been recorded due to COVID-19 pandemic and that some of the deaths recorded as COVID-19 deaths were actually deaths that had occurred for other reasons. We are sailing in the dark, with no compass or stars, concluded Marko. He decided he would trust no one – neither scientists nor that English epidemiologist and prognosticator Ivor told him about. The only thing left to do was to be afraid, but rationally.

## AGAINST EXCESSIVE IDEOLOGY IN THE PANDEMIC DISCUSSION

Marko, the hero of the last chapter, showed us what the beginning of the pandemic looked like in the eyes of an “ordinary” but mature and educated man who was trying his best to protect his family. The ideological dimension and most of the information were worthless to him, including the predictions offered to the public in the early days of the pandemic. Then what must have it looked like in the eyes of politicians, who pay more attention to ideas and ideologies than a mathematician?

Ideas and ideologies are presented as articulated in order to be acceptable for those who think superficially. But they are usually contradictory or, at best, incomplete. This is usually exposed in the conditions of social stress, when ideas are tested in demanding social situations in which they are being applied. Hence the conceptual and ideological confusion created by the pandemic. It was a shock for the people who were trying to explain the world through simple concepts and ideas, without using data or analyses. This is why the first attempts to understand and explain the anti-COVID-19 measures were not only imprecise, but totally wrong in most cases. They became so twisted that left became right and black became white.

Commentators tried to pin ideological characteristics to the countries’ reactions to the pandemic. In the beginning it was claimed that some countries (e.g. United Kingdom, Netherlands, Sweden) had been using a version of the “liberal approach”. Some called it “Darwinist” approach because the countries did not introduce radical lockdowns. Most commentators explained it this way: When the virus has spread enough that a sufficient percentage of people develop antibodies, society will acquire the so-called “collective or herd immunity” and/or a vaccine will be developed. True, more people will have died because of that, but the price would be “acceptable”, believed the alleged liberals or interpreters of liberal views.

The above strategy is based on the premise that natural selection will eliminate the elderly, the sick and the feeble. This is the alleged “liberal”, Darwinist

worldview, the one that confused Marko in the last chapter. The opposite, interventionist approach to the fight against the virus was presented as leftist and centrally planned: As an extremely harsh lockdown was introduced in China, and China is a communist country, it probably meant that the strategies used there were leftist and centrally planned. Seemingly, it all fits: the continental Europe, known by its inclination towards state interventionism, has taken the similar course as China, unlike the more liberal Anglo-Saxon world and part of the Scandinavian world.

### CAMERA OBSCURA

What could be wrong in the above logic? As if you were solving a rebus puzzle or one of those graphic puzzles, search for the Borg in this story. The real Borg – the one from *Star Trek* – a collective organism in which individuals are irrelevant because their purpose is to ensure the functioning of the collective. Here's a little help: the COVID-19 virus problem exists because of the long waiting lines outside the health-care system. If there are many infected then there are not enough hospitals, doctors, beds in intensive care units and ventilators. Those in a life-threatening condition are left to wait. Many in this waiting room die without medical treatment. The politicians who cannot solve the problem of allocating adequate health-care resources delegate to physicians the decisions that the latter ones are morally not capable of making. But they have to, because they have no choice. In conflict with the Hippocratic oath, physicians decide who will be admitted to the intensive care unit: Who will live – Ivan (48) from Split or Ana (72) from Dubrovnik? Gianna (55) from Bergamo or Giacomo (89) from Milan?

The strong interventionist reaction aims at avoiding any deaths while waiting in line outside the health care system. Every person is important and matters equally. The allegedly non-liberal interventionist strategy is characterized by an intention to fight for every man and by caring for the overworked physicians who are forced to play God – something humans, with due respect, should not do. Isn't this allegedly non-liberal interventionist solution in fact liberal, because it aims at giving an equal chance to every man?

Still don't get which strategy rests on individualist values and which one on collectivist values? OK, let's try once again, but this time from a different angle:

the strategy that has been called “liberal” (reportedly the “Anglo-Saxon” or “Swedish” strategy) relies on acquiring collective immunity. The social Darwinism linked with this strategy rests on the belief that it is the group (usually the people who live in a particular country) that should survive. To put it more simply, society is to live, not the individual. The individual does not matter because he or she is old or is just a cog in the social mechanism. It is assumed that the issue of the survival of the collective can be separated from the survival of the individuals constituting the collective. Isn’t this the Borg – the true essence of collectivism?

So, when we called the Borg-like strategy “liberal” and the individual strategy “interventionist”, was it actually not a mirror image of the world, with reversed sides? If so, can the Chinese approach to the pandemic problem – the radical lockdown – really be considered liberal because it argues for equal chances for everyone? Regardless of whether we analyze the anti-pandemic measures through ideological glasses, as most commentators do (liberalism = “Darwinism”), or we rely on the mirror image described above (liberalism = “radical lockdown”), the ideological prism has turned out to be futile for understanding and developing anti-COVID-19 measures.

#### LIBERALISM AND INTERVENTIONISM: MISCONCEPTIONS

Those who are not particularly familiar with the liberal idea think that liberalism is characterized by lack of interventionism. This is wrong. Liberalism implies the interventionism intended for protection of individuals. Liberal civilization has laws that protect human lives, rights and property. It can be described as freedom within order. Social liberalism, with its origins in the ideas of Adam Smith and, in particular, John Stuart Mill, protects health, right to education, and equality before the law. This means that liberalism and interventionism are compatible to an extent (although not always). On the other hand, the idea of acquiring collective immunity through inaction is – logically – collectivist. This idea is based on a policy that relies on spontaneous processes and noninterference with nature. Only superficial observers can perceive it as liberal spontaneity. In fact, the policy of merely letting the virus spread counts of the Borg-like collectivity and does not care about what happens to individuals.

But, let's get back to reality: is there a country in the world where the government passively observes what is going on, hoping that collective immunity will be attained? It seems there isn't, at least not in Europe. In reality, states have devised different measures because they perceive differently the short-term and long-term effects of lockdown and the outbreak dynamics. Still, all of them have intervened, intensively, from day one. This is why static perspective should be replaced with a much more realistic – dynamic – perspective, which takes into account real interventions and their long-term effects. For this reason, the analysis in the text below will be much more productive if we throw away the superficial ideological glasses. An insight into details will show that there is something wrong with simplified ideological models – they tend to fail the test of reality. They divide people and give no guidance for better understanding.

#### EXTREME CONFUSION

Prior to any empirical considerations, we will perform another ideological twist – the third one – in order to blur the ideological glasses to maximum. The first twist was when we, superficially and erroneously, abolished distinctions between liberalism as Darwinism and leftist approach as interventionist. The second twist was when we, using a mirror image, linked liberalism with the radical restrictions aimed at protecting every human life, wondering with concern if it meant that China had been implementing an anti-pandemic strategy based on liberal values. That is confusing. We are now going to analyze the conditions in which that liberal approach will acquire some characteristics of individualist values in the next circle of complexity.

Let us imagine a perfect digital democracy in which informed citizens vote which anti-COVID-19 strategy is to be selected – the absolute, indefinite lockdown (until the virus is contained) or the collective immunity strategy that includes the spreading of the virus, waiting in lines outside the health-care system (where people die) and allowing more than 99% of the people to go on with their more or less normal lives. The information-communication system used for voting records voters' age. We can imagine a country where 90% of people vote for a radical lockdown at the beginning of the outbreak. However, as the lockdown persists, the economy collapses, fear eases and the vote chang-

es. Most people – not just most of the overall population, but also most of the elderly, who face the greatest risk – will vote for a solution that will make the economy function again. Schools must reopen. They do not vote this way “for profit”, but because they care about education of young people, living standards and society’s ability to fight off future threats. The strategy changes because decision-makers listen to what people have to say.

So, is this the Borg or is it liberal democracy, despite society’s intentions to attain collective immunity? What if the voters in a democratic procedure opt for collective immunity as their desired anti-pandemic strategy because they have estimated that social losses in an open society are lower than those in a closed society? The moral of the story is that antivirus strategies and their ideological characteristics depend on circumstances and are hard to fit in a rigid ideological framework.

The opposite is also true. The model formerly perceived as a centrally planned model, that has in the meantime turned out to be liberal when its mirror image is observed, treats every man equally and fights for every human life. However, it may not be that liberal if the dynamics of social processes in a hypothetical undemocratic state is analyzed. Let us imagine a similar voting model in a country which is not a liberal democracy but has introduced a lockdown claiming it wants to save every human life. A change takes place: after 60 days of lockdown and a collapsing economy, the majority that supported the continuation of such a situation suddenly becomes a minority. As for the elderly and the sick, a minority of them now votes against radical emergency measures because they are worried not just about their own lives, but also about the lives of their children and grandchildren. But the purpose of the vote is to probe the public opinion. The measures are decided by the National Civil Protection Authority (NCPA), consisting of administrators and a few experts from the ruling party. Although the citizens’ attitude has changed, NCPA persists on the lockdown model. The government propaganda keeps claiming that the model is liberal because it treats every human life equally. After a few weeks, there is a mortality growth among the elderly due to the stress caused by loneliness, despair (in those without families), hunger and a growing suicide rate. The administrative control has resulted in shortages. Unemployment has grown substantially. Prolonged forced stay in cramped apartments results in conflicts within families. Domestic violence is growing, smuggling is on the rise and so is organized crime. Resistance against NCPA

is also growing. NCPA is trying to control the situation by blocking access to social networks. There are riots in the streets but the army are dispersing them with water cannons gushing disinfectants. NCPA cannot admit their mistake, because its members know that the change of strategy would mean the change of government and that they would probably be put on trial. The army has been mobilized and is now patrolling the streets and raiding apartments of suspected opponents of the regime...

### THE REALITY IS DIFFERENT

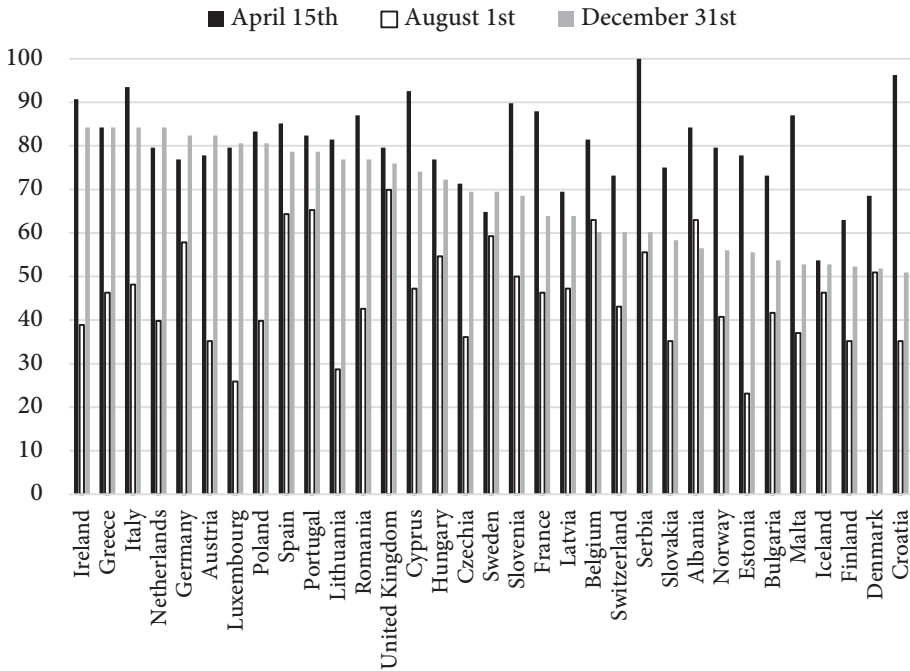
The reality of the pandemic consists of the shades of gray that we cannot perceive well with our senses, traditional categories and ideological concepts. We should therefore begin with the data about the measures introduced by individual countries. Figure 3 shows Oxford Stringency Index for European countries on three important dates in 2020: 15 April (the peak of restrictive measures in the first wave), 1 August (relaxation of the measures during the summer intermezzo between the two waves) and 31 December (around the peak of the second wave). On average, the stringency was the highest in the first wave: 80.2. The next one followed in autumn, after the summer relaxation, but the measures were less harsh than in spring (on 31 December, the average was 68.3). At the same time, the differences between the countries had grown: while the standard deviation of the Index was 9.9 on 15 April, it was 11.9 on 31 December.

Every country was trying to find its own way within the general trends shown. The measures introduced by Greece, Netherlands, Ireland, Italy, Germany, Austria and Luxembourg during the second wave were either more restrictive or equal to those during the first wave. The measures of Slovenia, France, Belgium, Serbia, France, Albania, Norway, Estonia, Malta and Croatia were substantially weaker during the second wave (by more than 20 points than during the first one). But all the indexes in both waves were higher than 50.

The stringency cannot be linked with health outcomes (remember Figure 2 from Introduction). For example, the countries with the weakest measures during the second wave include both the ones that were hit relatively hard (Croatia, Bulgaria, Albania, Slovakia) and the ones that had relatively low

COVID-19 death rates or COVID-10 comorbidity death rates (Denmark, Norway, Iceland, Finland, Malta, Estonia).

*Figure 3 Stringency index in 2020 (Max. = 100)*



Source: OxCGRT.

We can assume that the measures were changed between the two waves due to specific local circumstances. The change was the result of the predominant doctrines of local expert advisors of governments, politicians' convictions, reactions of the public, and the dynamics of the virus spread. In some countries, more restrictive measures were introduced because further deterioration was anticipated (in technical terms, measures were exogenous). In other countries, such measures were introduced only after the second wave had arrived (they were endogenous). Measures remained relatively relaxed in the countries that were not hit by the second wave (also endogenous – more stringent measures were not needed). This is why comparative analysis cannot help us identify the effects that the restrictions had on the ultimate value crucial for both citizens and politicians – the death rate. But this does not mean that restrictions can-



not have any effect on the outbreak. It is just that the method shown here has not discovered that effect.

Croatia's case also illustrates the crucial role of circumstances. During the second wave in autumn 2020, Croatian government was aware that the measures in place were much weaker than those in other countries. The public had constantly demanded more restrictive measures. Remember the case of the Croatian scientist from Canada who joined the experts' appeal for more stringent measures in early December 2020. The government conceded and, just before Christmas 2020, introduced new restrictions. Like in spring 2020, the measures included ban of movement between counties. All of a sudden, those who had signed the appeal started praising the government. But the more critically oriented experts asked: While closing down regions and cities within a country theoretically makes sense if the pandemic has not spread in them yet, what is the purpose of this if the virus has already spread everywhere? If not a single individual crossed from one county to another, the virus would nevertheless continue to spread within the counties where it is already widespread.

Clearly, some of the measures were merely an alibi; they were introduced because the government wanted to prove that it was ready to react, not because it believed that these measures could be efficient. Similarly, restaurants and gyms were shut down although analyses had shown that the chances of contracting the virus in them were small. At the same time, shopping malls remained open.

This ban of movement between counties did not last long. Again, because of the circumstances. A few days after the Christmas 2020 restrictions, a strong earthquake hit an area 40 kilometers southeast of Zagreb. There were seven fatalities. The nation was once again under double stress – from the pandemic and an earthquake, like in March, when an earthquake hit the national capital, Zagreb. The government was aware that the ban of movement between counties was questionable; it had been introduced as an alibi and would not be possible to control after the disastrous earthquake. So the ban was abolished only days after it had been introduced. There were no consequences: the downward trend of the pandemic in Croatia continued in January 2021 as if nothing had happened.

We rarely have an opportunity to witness the accidentally well-designed natural experiments that, as in the above described case, help us become aware of (in)efficiency of specific measures. Speculations, fumbling in the dark and the

use of the trial-and-error method are common, as lack of knowledge and reliable information can usher in mistakes, misconceptions, misinterpretations, manipulations and improvisation. These were the distinguishing features of the atmosphere in which the measures were introduced. Not just in Croatia. The relevant studies that were occasionally published in scientific journals in 2020 were of no help either. Their results differed. Clearly, there was no consensus among scientists about the effects of the measures.

The case of Sweden is also a good example of defying simple ideological categories. Although Sweden merely tried to deal with the pandemic without violating fundamental freedoms and rights, European media perceived it in 2020 as the torchbearer of the collective immunity strategy – the cursed “liberal Darwinism”. At the peak of the anti-Swedish campaign in Croatian media, in April 2020, backed by influential government advisors – the lockdown supporters – the Swedish approach was likened with Nazism and accused of intentional killing of the elderly population. However, Figure 3 indicates that Swedish measures were at all times around the European average. In the first wave they were slightly below average (64.8) and in the second wave they were slightly above it (69.4). Particularly interesting is the fact that the stringency index for Sweden’s second wave was higher than the indexes for other Scandinavian countries, which had recorded a slower growth of the numbers of infected and of the COVID-19 death rates.

Still, numerous commentators in media and on social networks, advisors and influential opinion-makers claiming to speak as fabled experts did not present the above facts. Instead of communicating numbers and results of analyses, they merely offered their own ideas and ideological interpretations of the phenomena. Basically, they offered ready-made “knowledge” that not only ruled out, but also morally condemned or humiliated any opposing opinion. How could politicians make rational decisions in such conditions?

## CRUCIAL ROLE OF CIRCUMSTANCES

We showed earlier in the text that political decisions depended on circumstances more than on ideological concepts. And when it comes to viruses, circumstances can depend on season (one strategy is good for summer, some other for autumn or winter); health-care system capacities and skills (higher

capacities mean less fear that some lives will be lost due to lack of treatment); perception of the economic cost of total freezing of economic activities (e.g. expected depth and duration of the recession and its aftermath); prospects of developing a cure and/or vaccine and, first of all, the characteristics and lethality of the virus.

The crucial role played by context is particularly visible when comparisons with the last major pandemic are made. SARS-CoV-2 is a highly contagious virus but is characterized by a lower mortality rate than the first SARS (the one from 2003) and by a higher mortality rate than H1N1 virus (swine flu) during its last pandemic (2009-2010). N1H1 virus was allowed to spread freely despite the fact that approx. one billion people were infected. The mortality rate was very low – it is believed that between 150,000 and 575,000 people died worldwide in 2009 and 2010. As the global COVID-19 mortality reached 2.3 million on 5 February 2020, it is clear that SARS-CoV-2 is much more dangerous than H1N1. But this is not the only reason why H1N1 attracted much less attention than SARS-CoV-2. In 2009-2010 the world was in the middle of the great financial crisis that had begun in 2008-2009. As production was plummeting and unemployment rocketed sky-high everywhere, no one was particularly keen of paying much attention to a virus with a low mortality rate. There were much higher priorities than introducing restrictions that would clearly result in unbearable economic losses. It would be like putting out the fire with gasoline.

Consequently, the last two pandemics had different effects on the behavior of people and governments not just because SARS-CoV-2 was clearly more dangerous. These differences cannot be understood outside the context of business cycle: politicians around the world were convinced that, after a long cycle of growth that preceded the outset of the pandemic in early 2020, economies were resilient, employment rates high, and fiscal and monetary capacities for absorption of a one-time impact almost infinite. This is yet another confirmation of the principle that circumstances dominate over ideas and ideologies. This principle can be summarized as follows: *Although serious politicians symbolize and nurture social values and ideas and are trying to differ from each other by the ideologies they stand for, political reactions are determined by overall circumstances more than they are determined by ideas and ideologies.* After all, the Swedish strategy, often (mistakenly) labeled as inhuman and Darwinist, was carried out by – Social Democrats. Of course, it does not mean that Social Democrats had

turned Darwinist overnight. It means that the initially offered ideology-based explanation was totally futile. But this fact cannot compensate for all that flood of insults directed at the Swedes in European media in spring 2020.

## MORE ON EXPERTS

In major crises, decisions always are – and should be – political. There is no point following unquestioningly everything that experts in some profession say. In complex social crises, perspectives are always multilayered. A good politician or political leader is the one who – by using universal knowledge – rationally ponders various professional perspectives and information in searches for some middle (overall) social perspective that takes into account all the essential elements of life of all generations, including the future ones.

Macroeconomists know very well how it works. If accepted, their recommendations are translated into economic policy decisions. As a rule, political decisions differ from recommendations. Every first-rate macroeconomist would have no problem developing an optimal fiscal policy that could maximize social wellbeing in a long-term model. She could also calculate optimal intergenerational financial relations because public debt and government investments are cross-generational phenomena; this is because the next generation inherits not only public debt, but also public assets – both tangible (roads and bridges) and intangible (political system; knowledge and practices of public administration; cultural norms). But macroeconomists are not allowed – and never should be allowed – to discuss important things in the capacity of fabled experts and impose on politicians the packages with ready-made solutions. They take part in public debates, offer recommendations, some even become ministers (thus changing the nature of their work), but the principal limitation that the experts' ideas are faced with is called – life and politics. It is the ideas, interests, political and other circumstances (in addition to expert recommendations) that matter and they are valued by the politicians with electoral legitimacy who make decisions in the name of the people.

However, democratic immaturity of a society and/or exceptional circumstances can create an imbalance in the relations between experts and politicians. Those who are in power face a very difficult task: they must be able to pick out good advisors among experts and to tell relevant advice from advice

based on mistakes or interests. In democracy, all this should be done in a way that will strengthen public trust in the government and institutions. It is a very hard job. For example, Croatia is still an underdeveloped democracy in many ways and its citizens are not particularly familiar with the essence of democratic politics. Politicians are often criticized for “not being experts” or for “not listening to experts”. However, critics forget that politics is a profession like any other and that experts from other professions are not politicians but often have their own agendas or lack critical assessment of their own work and recommendations. The media bullhorns who lack the ability for critical analysis of contents often spread the myth that the philosopher’s stone actually exists. This is why a good politician or political leader must have some universal qualities and be able to, at least superficially, grasp various perspectives and perceive a wide range of information. In order to be good at their job and not be just puppets on a string, persons with such universal qualities must possess two crucial skills: ability to recognize interest-based or ideology-inspired viewpoints and ability to recognize the limits of knowledge.

Interests are tough. Often dressed in some nice outfit – usually some popular moral attitude or scientific myth – they are hard to see through. Interests can overwhelm us even when we decide on anti-COVID-19 strategies. Experts can present the danger of the virus as bigger than it really is, even unconsciously. The politicians inclined to authoritarian solutions can feel that their moment has come and introduce total control of the population, using humanistic motives as an excuse. They can call for flag-waving, as if flags will scare the virus away. On the other hand, economists and entrepreneurs can, also instinctively, present the virus threat smaller than it actually is in order to maintain economic activities. A good politician or political leader must be able to ponder various social perspectives and take into account the impact of bias arising from different interests.

## LIMITS OF KNOWLEDGE

The line between the issue of interests and the issue of identifying the limits of knowledge is very blurred. These two subjects are closely entwined. Generally, it is easier for incoherent ideologies and strong interests to penetrate to the domains where knowledge is inadequate. Also, while persons who are aware

that their knowledge is inadequate or lacks credibility tend to look hesitant and too cautious, even incompetent, those driven by ideologies and interests generally strike one as resolute and strong (this impression is often disguised as “knowledge”). The latter type of people is louder and talkative and often uses metaphors, which makes them dangerous – they easily win followers.

We do not talk about the cases when knowledge is there but has not yet been acquired by those who are supposed to. We talk about the cases when knowledge does not exist (because it has not been produced yet), but the impression is being made that it is actually there. The latter was often the case in the first year of the pandemic. A wise politician should be able to sense such a situation and do everything he can to change it.

How does one recognize such a situation? When coronavirus appeared, almost nothing was known about it. Little by little, we learned something, but the key parameters for relevant health, political and economic decisions remained unknown for quite a while. As regards the most important thing – the actual risk of contagion and death – there are still many unknowns, particularly potential years of life lost. The situation in early 2020 was best described by John Ioannidis, a professor of epidemiology, biomedicine and statistics from Stanford (2020), in a text in which he argues that this “pandemic of the century” could turn into a “fiasco of the century”: “At a time when everyone needs better information, from disease modelers and governments to people quarantined or just social distancing, we lack reliable evidence on how many people have been infected with SARS-CoV-2 or who continue to become infected. Better information is needed to guide decisions and actions of monumental significance and to monitor their impact.”

Ioannidis also reminded that being positive to coronavirus did not mean the virus would be responsible for everything that would happen with the infected person from the moment when he or she became infected. This is why the numbers of coronavirus deaths are very inaccurate. In the end he warns that there is no evidence of any particular efficiency of radical solutions such as lockdown. He concludes: “If we decide to jump off the cliff, we need some data to inform us about the rationale of such an action and the chances of landing somewhere safe.”

Do Ioannidis’s views reflect liberalism understood as social “Darwinism” or are they merely a rational warning given by a scientist whose conclusions are based on evidence? According to Google Scholar H-Index, Ioannidis is the

sixtieth most cited scientist in the world. And yet, throughout 2020, he was under a heavy barrage of criticism of lockdown advocates. The pandemic is not over yet but, if we rule out some extreme contingencies such as unusual mutations of the virus, the data presented in the introduction seem to confirm that Ioannidis was right: although COVID-19 is indeed a nasty disease, some reactions were exaggerated. The lesson for today and for all future cases is: rational decision-makers should know how to identify the extent of ignorance that surrounds them and should ensure funds that would make this cloud of ignorance disperse.

One such example of investing in dispersion of the cloud of ignorance is the regular longitudinal testing of seroprevalence that can indicate the actual spread of the virus and thus eliminate an important unknown – the difference between the officially recorded and actual numbers of the infected. This is important for assessing the situation and the expected pandemic trends. Although the abovementioned Professor Lipschitz from Harvard proposed that such tests be carried out at the outset of the pandemic, it took quite a while before it was actually done. Lipschitz's proposal is the only way for society to stay calm in the situations like this and to be able to make the best decisions in public interest. When we lack information about the real situation, chances for a mistake are huge. And if such a mistake happens, it is rather irrelevant whether it was a result of some ideology or interest or benevolent ignorance or lack of information.

At the end of Chapter 1, Marko the mathematician concluded that we were sailing in the dark and that he should be self-reliant and trust only his own intelligence and no one else's. This conclusion reflected his intelligence and his lack of trust in anyone that only partially arose from the objective complexity of the pandemic issue. Marko found a rational answer after he had concluded that there was no one in the public space who could pursue evidence-based policies with assurance.

Of course, in the complex and hard conditions of the pandemic, it is hard to determine or recommend what should an evidence-based policy look like. Still, one cannot help feeling that – not only in Croatia – the space for pursuing rational policies that was objectively there was not used. If there was any dilemma in spring 2020 whether it was wiser to lock ourselves up in our small prisons or, for example, invest a few billions in public health care and computerized statistical systems to obtain real data in almost real time and



radically increase the capacities of medical staff and equipment while going on with normal life at the same time (with necessary precautions such as hygienic measures, wearing face masks, avoiding mass gatherings and keeping social distance), in winter 2021 such a dilemma was even more diluted. There are growing indications that the overall long-term cost of the standstill of normal life is higher than the questionable benefits from the measures that have impinged upon the fundamental human rights and freedoms. Even before the end of the pandemic is officially proclaimed, it seems that liberal democracies are capable of finding a way of balancing people's health, safety and freedom. In spring 2020, it didn't seem they could pull it off.

#### KNOWLEDGE AND DEMOCRACY

Having a democratic system is an indispensable condition and an opportunity for those who make collective decisions to be as close to the above described model of a rational politician as possible. Democracy allows for the circulation of information and knowledge in society to enable constant questioning of political and public-health-related decisions in order to ensure their best possible quality. The same applies to other areas of policymaking. Constant questioning, testing and adaptation (together with the differences between countries that inevitably emerge in this process) can ensure opposition to the totalitarian scientific uniformity of the single truth which is being imposed under the auspices of scientific authorities. There is no doubt that some scientific truths, if truly verified, should be imposed. But it will not happen simply because an influential advisor has invoked some authority. It will happen spontaneously because numerous scientists, experts and commentators will realize after some time which recommendation is correct. Until a large majority agrees about a particular issue, suppressing criticism and imposing false uniformity of viewpoints could be fatal.

In its essence, the liberal-democratic approach to developing the knowledge required for finding the best responses to the pandemic is opposite to the Chinese approach. The main difference lies in the process of development of the best possible measures under the circumstances. But this principle was put at risk at one moment in the beginning of the pandemic. A single truth was imposed – the Chinese approach to the fight against the pandemic and a radical



lockdown regardless of the cost. The liberal-democratic principles were sacrificed to the imposed moral blackmail – the false dilemma “life or profit”.

Politicians are the only social actors that can bring together (and confront) the representatives of various professions and listen to what they have to say in order to get a complete picture of the social costs and benefits. Epidemiologists and other public-health experts will be able to estimate (to an extent) what various subtypes of lockdown mean in terms of delaying deaths of the most vulnerable people, but they will not be able to estimate other social costs resulting from lockdown. Oncologists will be able to estimate (to an extent) the consequences of delayed detection and surgeries of cancer, but they will not be able to estimate the losses resulting from the spread of the pandemic. Psychologists will be able to estimate (to an extent) the consequences of growing domestic violence and depression and educationists and economists will be able to estimate (to an extent) the loss of the expected remaining lifespan due to shutdown of schools and businesses. But they will not be able to estimate the effects of the outbreak-containment measures. And the ones that are able to do it will not know that Christakis et al. (2020) estimated the dramatic effect of lost education on children in the U.S. (approx. 14 million potential years of life lost) and the somewhat less dramatic effect on the EU children (approx. 0.8 million).

The expression “to an extent”, persistently repeated in brackets, is a reminder that the estimates are not reliable. One should always interpret the above figures as “around 14 million” and “around 0.8 million”. This is to say that the range of possible estimates around these mean values has to be very wide if we want to be 90% or 95% certain (and even wider if we want to be 99% certain) that the actual value will not be outside the interval of confidence. In other words, the certainty of a result and the ready-made knowledge packages for complex social problems are mostly illusions created when the problem of estimation is disguised or because scientific models are fundamentally incomplete.

At one moment (in March 2020), the world forgot about all these limitations. The combination of circumstances that included an escalation of fear of an unknown disease, ideological manipulations, career opportunities, political interests, commercial interests, inadequate capacity of administration and politicians and a number of other factors led to a brief capitulation of judgment. The idea of the fundamental value of freedom also capitulated at the same time. For a moment it seemed that some elements of freedom could be

sacrificed if that meant saving human lives. Almost nobody thought that it meant threatening some other lives.

The readers should be warned that the conclusions offered in this book should be taken with reserve in order to avoid repeating the mistakes of those who we criticize. This primarily refers to the problem of the effects of the most radical measures. We do not claim that the radical restrictions that deeply affect our fundamental freedoms (e.g. freedom of movement, right to work and entrepreneurship, right to equal treatment in primary and secondary education) cannot reduce COVID-19 mortality rates. The intention of this text is to show the problematic nature of the long-term effects of such measures: there is a possibility that the long-term social losses resulting from the lockdown will exceed the short-term benefits resulting from radical measures.

Even more important is the fact that renunciation of the fundamental freedoms and rights incurs a danger of an incalculable social loss – a change in the dominant values and political institutions in liberal democracies. This cannot be expressed statistically because calculations that take the expected life years as a starting point do not provide answers to the following questions: Are these years of good or bad life? Is it life in bondage or life in freedom? Will we spend these years free to try to realize our human potentials or will we spend them scared in Kafkaesque corridors, waiting for orders and permits approved for us by Big Brother? A model that could turn this picture into numbers has not been designed yet; it is our values that provide results.

## DEMOCRACY AND DICTATORSHIP

In the first chapters of this book we saw how a combination of fear and ignorance created ideological conflicts and moral blackmails, suppressing the liberal-democratic instincts such as criticism, skepticism, questioning and controlling of the decisions made by the government and its visible and invisible advisors. All of a sudden, encroachment on fundamental freedoms and human rights has become acceptable without questioning its proportion with the short-term COVID-19 containment effects and long-term social, psychological, economic and political consequences.

“Better safe than sorry” is a well-known saying used for justifying sudden reactions in the face of grave danger. But there is another saying: “The road to

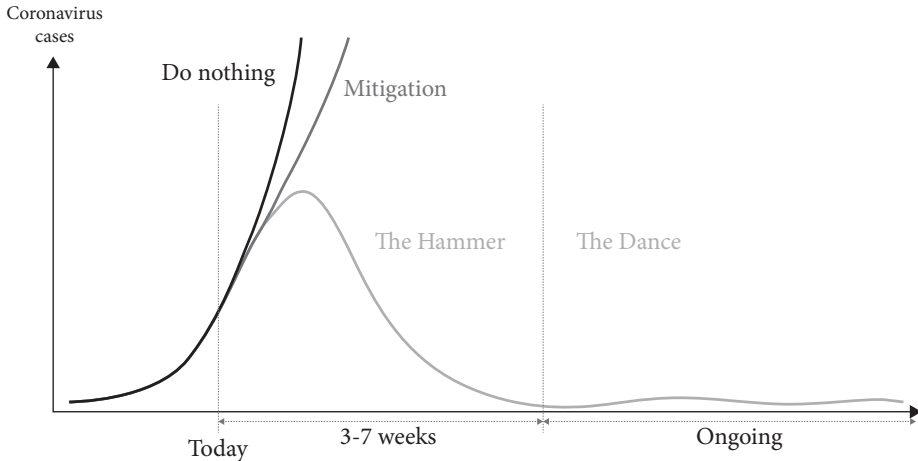
hell is paved with good intentions.” This one serves as a reminder that a sacrifice made at the altar of safety can sometimes unexpectedly grow.

As time goes by, we are approaching the point where these perspectives will hopefully reach balance. The further from the initial explosion we go, the better we can understand the situation. There is no doubt that China played the key role by initiating the process. Not only because the mythical city of Wuhan (where the virus first appeared) is in China, but also as a society that demonstrated to the whole world one possible model of the fight against the virus. Despite the skepticism caused by the initial cover-up of the outbreak and general distrust of Chinese data, China’s radical lockdown approach seems very efficient – something like ripping a band-aid off quickly, following the principle “short-term pain, long-term gain”. If we ignore the moral and political dilemmas about the methods used (such as stringent lockdown, electronic tagging and draconic penalties for offenders) and concentrate on the results, we will notice the following: China officially has less than 100,000 infected; the last recorded cases of infection and death were in April 2020; China’s economy grew approx. 2% in 2020 (approx. 4 percentage points less than expected before the pandemic, but a growth nevertheless, as opposed to the major economic decline of the Western democracies). Should we not use Chinese approach to the fight against the virus as a role model after all? Isn’t it obvious that the resolute lockdown response actually saves economy in the long run?

These are the resonating issues. There is no doubt that Chinese model still lives in decision-makers’ minds. The possibility of containing the virus in such a wide area using a combination of scientific insight, public health measures and resolute government action is attractive to many. It is hard for Western democracies to ignore this fact, provided that the Chinese COVID-19 data are not whitewashed. Such a doubt will persist as long as China remains a totalitarian state with a one-party regime.

The phrase “the hammer and the dance”, used to describe the Chinese model, was extensively used in media and politics during the first wave of the pandemic (although it was not devised by an epidemiologist, but by a marketing expert on his blog).

Figure 4 “The Hammer and the Dance” model



Source: Pueyo, 2020.

If China really has managed to achieve the results it claims it has achieved by using the radical lockdown approach, we have to admit that the Chinese outcome has three advantages over the outcomes in Western democracies. First, the lesson about containing a dangerous virus can be useful if a new virus emerges which is more dangerous than SARS-CoV-2. Second, the economic cost of an efficient lockdown could be lower than that of a lengthy pandemic. It would be irresponsible, even crazy, to reject efficient measures for ideological reasons, simply because they were applied by a nominally communist country. Ideological bigotry – refusing to offer people a sense of health, safety and prospects of economic growth because of abstract ideas of freedom – is another thing that could also endanger liberal democracy. After all, weren't Western troubles with the pandemic in 2020, at least partly, a manifestation of the hesitation and political anemia that come from within, from the exposed weaknesses of modern liberal democracies? Maybe this is how the Chinese see us: reluctance to make difficult decisions and political hesitation disguised as a concern for abstract individual freedoms, while, in fact, what people really want is not freedom but safety and action.

Observed through the prism of real GDP per capita, China's level of development is currently approximately the same as Northern Macedonia's and Serbia's, which is around 40% of the EU-27 average. However, it is China's huge

population – more than 1.4 billion people – that makes the country nominally the third economy in the world, after the U.S. and EU. But, given its prospects for growth, China could become the world's nominally leading economy. These are some of the thoughts in the heads of the politicians who keep their ears to the ground, pragmatically trying to fathom the policies and measures that would help them get reelected.

Let us leave China aside for the rest of this chapter because the second part of the book is dedicated to it and the third part – the story of the five horsemen of the apocalypse – explains why there are no guarantees of efficiency of China's approach. The purpose of the rest of this chapter is to explain the moment that Europe is in at the end of the second wave of the pandemic in late February and early March 2021.

We have seen that the difference between the measures introduced by countries after the peak of the second wave were bigger than the differences between the measures in the first wave, although the outcomes of the pandemic when it comes to COVID-19 death rates per million are more similar today. Every country chose its own way, largely depending on local circumstances. By analyzing the stringency indexes, we came to conclusion that some European countries introduced more stringent measures during the second wave: Greece, Netherlands, Ireland, Italy, Germany, Austria and Luxembourg. These European countries, led by Germany, opted for continued stringent strategy in the second wave. The question is: are there limits to the “better safe than sorry” strategy?

## RISKS ARE INTERCONNECTED

In October 2020, China's leading business magnate Jack Ma (Alibaba), made a public speech after which the Party decided to put him on ice by placing him in isolation. Ma made a short public appearance in early 2021, but said nothing about his absence. It all started when Ma criticized Chinese financial regulators who, at the last minute, interfered in the initial public offering of the stocks of part of his business empire (Ant Financial) which controls a large portion of the payment operations in China. It was confirmed later that Chinese anti-monopoly agency had placed Ma's megacompany under control.

Payment operations are often dubbed “bloodline” or “critical infrastructure of systemic importance”. It is no wonder that all states find ways of controlling their respective “critical functions”. Such efforts are not without justification. The only difference lies in the methods used, and in the results obtained. The same goes for the epidemic control measures. This begs the question whether parallels can be drawn between Jack Ma and his “critical infrastructure” that became an object of the state’s considerable interest on the one hand and the pandemic-control measures on the other.

In his contentious speech, Ma said the key sentence that cuts to the heart of the matter: “Oftentimes, managing risk down to zero is the biggest risk.” Leaving aside who’s right and who’s wrong in the conflict between Ma and his government, this sentence can serve as a great introduction to this section. We will slightly rephrase it to make it clearer: *Can managing one type of risk down to zero lead to disproportional increase of other risks?*”

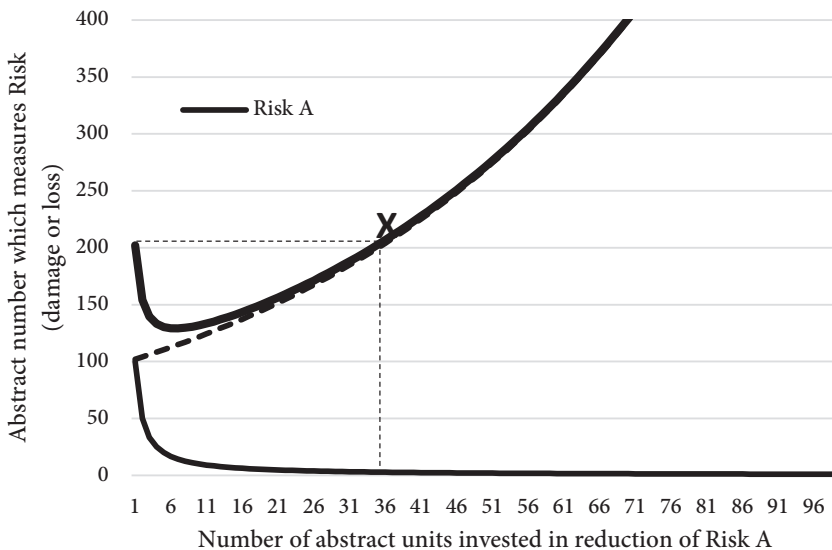
Risks are interconnected, often in invisible ways. This is why the complex system of mutual connections between various types of risks must be considered when managing risks. The fact is also that these connections are anything but simple (linear). So, in order to interpret the problem correctly, first we must know something that students learn in the first year of economics – the law of diminishing returns.

Imagine you are an accountant with your own accounting firm and a growing number of clients. So far, you’ve been making 180 book keeping entries per hour or 3 entries per minute. You’ve been very efficient in your 8-hour workday. Now you are about to increase your workload by increasing the number of working hours from 8 to 10. Everything is fine in the beginning but at the end of the tenth hour you feel that your eyes and your mind have become somewhat slower and you think that you are now making only 2 entries per minute. Still good... Then you make further efforts, extending your workday from 10 to 12 hours. You also carry your workload home. You are distracted by the TV and kids in the next room. After a while, at the end of the twelfth hour, you make only 1 account per minute. But you have to keep working, the workload is growing and the money is still OK... The point is: your productivity (return) per additionally invested time unit has dropped, although the total number of entries made has kept growing. If you go on like this for months and years, there will be new risks looming ahead: some effects (diseases caused by long-lasting stress) will appear with a substantial delay, but sometimes they

will emerge suddenly. Technically, these effects are not linear, some are even delayed.

In the above example we described the process of producing a service called “accounting”. Using the same principle, we can observe the process of producing a service called “reduction of risk”. Figure 5 shows that, in the beginning, investing in controlling Risk A soon reduces the risk. A parallel can be drawn with our accountant: in the morning hours, while he is still fresh, he manages to enter as many as 4 accounts per minute. However, as we invest more and more resources, the additional reduction of risk for the same investment gradually decreases, approaching zero. The fight against Risk A spends lots of resources (investment of the resources is shown on X axis), producing many negative side effects in the process. This is why further investment in the control of Risk A causes other risks B to grow. After major investments in controlling Risk A (moving along X axis to the right), the total risk (A+B) can be increased compared to the initial total risk. The critical point X in Figure 5 shows this. Investing up to 35 resource units (X axis) in controlling Risk A to the left of this point reduces the total risk (sum of A and B), but investing more than 35 units to the right of point X makes no sense because the total risk is growing and Risk A keeps decreasing very little.

Figure 5 Law of unintended consequences in isolated control of single type of risk



Imagine that X axis is used for measuring the stringency of anti-COVID-19 measures (Risk A) and that the dotted line is used for measuring a wide range of all other risks (economic, social, psychological, health-related): interrupted development of the children who do not attend school; explosion of public debt that can impair society's capacity for developing and financing health-care services in the future; delayed controls and treatments of other serious diseases (this, according to media, could be one of the pandemic's most tragic consequences). These are the delayed and mostly unknown effects of restrictive measures. They are described in Table 1 in introduction.

The example with delayed diagnosing of carcinoma illustrates the main problem with applying Figure 5 to the pandemic: we do not know where the curves are. We also do not know which risks do they consist of. We do not know does point X actually exists or is it just a figment of an analyst's imagination. The complex and delayed effects of the anti-COVID-19 measures do not enable constructing a line B that would statistically illustrate the extent of the problem (other risks) that we are facing.

The lack of statistical interpretation of the theory shown in Figure 5 is one of the principal reasons why the pandemic issue is dominant in the eyes of the public, media and policymakers. So far during the pandemic, everyone has behaved as if there is only curve A and as if it is defined; as a matter of fact, both lines exist but none is defined enough for reliable assessment and predictions. Marko the mathematician will be disappointed if he finds out about this.

## THE SECOND "LAW OF SOCIAL THERMODYNAMICS"

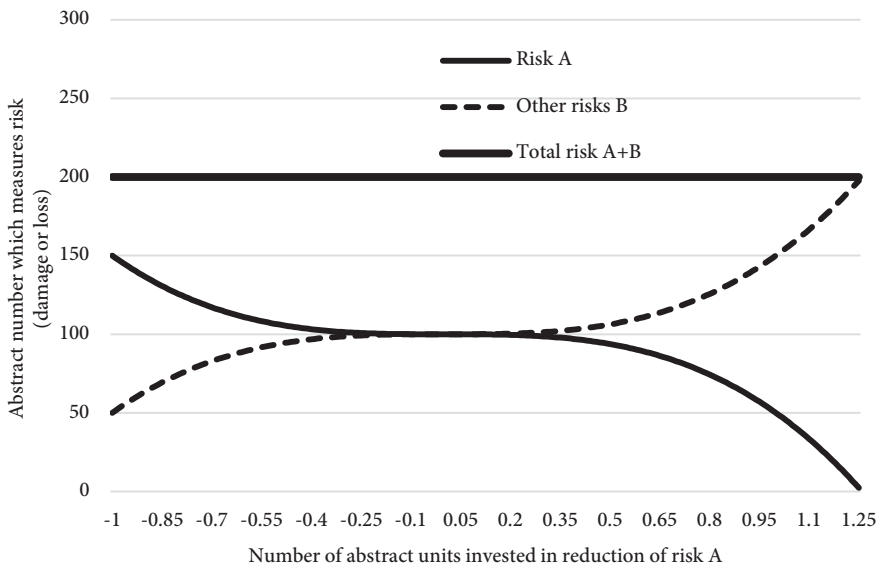
Figure 5 rests on the restrictive theoretical assumptions that may not be valid. It is implied that the total risk people are exposed to could increase (hence the upward trend of the total risk line  $A+B$ ). The risk management science of today tells us nothing about it; it allows such possibility, as well as two other possibilities: that total risks do not change (only their structure does) and that total risks can decrease. Our experience indicates that total risks can change. However, it is not a proven theorem, but an intuition, which may be wrong.

At any rate, the reality can be different than what Figure 5 shows. Figure 6 shows alternative specifications of risk functions which show a different reality because of different assumptions. Risk A curve exhibits a sharp downward



trend in the beginning (analogous to the morning hours of our fresh accountant). Then it proceeds almost horizontally for a while. And then something unexpected happens: when the already strict measures for controlling Risk A become additionally stringent (rightward along X axis), Risk A starts exhibiting an increasingly sharp downward trend. This right side of the risk function looks like *perpetuum mobile*: it counters the effect of the law of diminishing returns. It is as if our accountant would suddenly increase his productivity in the fifteenth hour of work (without any shots in the arm). While such possibility is contrary to the characteristics of many natural phenomena, there is not a single reason why we should not allow such possibility in the case of fight against the pandemic: very stringent restrictions can additionally reduce the risk A even after the variation of the moderately stringent measures has failed to have any effect on the risk change in the horizontal section of the curve.

Figure 6 Special case of constant entropy in society



The non-linear function A describes the Chinese case. It can also describe other cases with radical measures that could have taken effect in the later stage of the pandemic. We will show in the text below that it could have also happened in some European countries and in Israel before mass vaccination took

place, but let us first interpret the curve in terms of widely known concepts that are related to the fight against the pandemic.

First, in the left part of Figure 6, the measures manage to contain the pandemic at first (Risk A dropping). These measures include face masks, hygiene, social distance, gathering information, case isolation, education and appeals for responsible behavior. However, after the initial success, Risk A function becomes horizontal. No matter how much we invest in new measures in the central part of Figure 6, the risk will not change. This is the zone of the measures used as an alibi; they can be introduced or abolished, but will not have any substantial effect on the risk (as was the case with banning and reopening of traffic between Croatian counties around Christmas 2020). Only when the already stringent measures are additionally sharpened up – in other words, when social life becomes fully atomized – a new wave of effects reduces the risk. But the principal message of Figure 6 is that there's no such thing as a free lunch: further reduction of Risk A rapidly increases other risks B.

The analogy with physics – specifically, with the second law of thermodynamics – is scientifically unfounded. It is but a metaphor. Indeed, we cannot know in what ways are all the risks in society interconnected and whether the total risks in society can be increased or reduced. We do not know a lot about it because human society is too complex. To the contrary, Figure 6 shows a special case of constant entropy in a closed system – the constant total risk. This special case is far from reality but it comes in handy as a metaphor that illustrates the interconnectedness of risks. In this case the cost of reduction of one type of risks will probably be paid by some other people being exposed to some other risk at some other time. Jack Ma's fate illustrates this principle. His risks increased after the Chinese authorities had decided to reduce their own risks. This is why his sentence, "Oftentimes, managing risk down to zero is the biggest risk", is certainly worth remembering.

## TWO STRATEGIES IN THE SECOND WAVE

The key determinant of the second wave was the anti-COVID-19 vaccine that gave us hope of a definite triumph over the pandemic. When in October 2020 became clear that the second wave would be stronger than the first one, almost no one but a few in the know had any serious hope that the vaccine could soon

deal with the pandemic. When the first vaccines started obtaining regulators' approvals in early December 2020, euphoria took place. But two problems soon occurred. First, it became dubious whether sufficient quantities of the vaccine could be produced and – even more importantly – distributed to achieve the desired vaccination coverage by mid-spring 2021. Second, it is not certain how efficient the vaccines are against new strains of the (mutated) virus and how much time is required for the existing vaccines to adapt to the new strains. This latter problem is perhaps easier to deal with than the former one owing to the experience with the regular adaptation of seasonal flu vaccines every year.

At any rate, the combination of the three factors (vaccine, immunity and season), stands a good chance for substantial reduction of COVID-19 mortality rate in the remaining period of the pandemic. But European countries are currently on different trajectories both in terms of spread and in terms of anti-contagion policies. The countries with relatively low/reduced stringency indexes in the second wave include the ones that felt comfortable because of the generally low COVID-19 mortality rates (Iceland, Norway, Finland, Denmark, Malta) and the ones that decided to endure increased mortality rates while hoping to see the end of the pandemic with the help of interaction of the three abovementioned factors – season, vaccine and natural immunity (Switzerland, Slovakia, Serbia, Latvia, France, Croatia, Bulgaria, Belgium, Albania). Slovenia, Sweden, Czech Republic, Hungary, Cyprus, United Kingdom, Romania, Lithuania, Portugal and Poland fall into the middle group. The third group is the most interesting one. It includes the earlier mentioned Ireland, Greece, Italy, Netherlands, Germany, Austria and Luxembourg. These countries had introduced measures much more restrictive than those of other countries in the second wave; they implemented them consistently and, on average, recorded somewhat lower COVID-19 mortality rates in the second wave than the countries of the first group. This is why the segmentation of the European countries presented here enables identification of two different anti-pandemic strategies in the second wave. The first (we call it *hammer – dance – hammer – vaccine* or *the German strategy*) rests on the belief that introduction of very strong measures could contain the pandemic even in the second wave. The countries which followed this strategy can be seen to the right of the risk function A in Figure 6.

HAMMER – DANCE – HAMMER – VACCINE (IRELAND, GREECE, ITALY, NETHERLANDS, GERMANY, AUSTRIA AND LUXEMBOURG)

The well-known “hammer and dance” model is not adequate anymore (actually, it never has been) for understanding the strategies for the fight against the virus. The actual strategy in this group of countries can be represented this way: *hammer (outset of the pandemic) – dance (summer 2020) – hammer (autumn/winter 2020/2021) – vaccine*. The advantage of this strategic chain is the mortality control in the second wave (below one per mille until early March 2021), but its shortcoming is the fact that any problem with the vaccine (be it production, distribution or efficiency) can jeopardize the strategy’s success and threatens either with a long-term hammer (with all of its uncertain consequences) or with the second wave with tragic consequences such as growing COVID-19 death rates once restrictions will be lifted. If, in the end, the percentage of the deceased in the countries with radical measures is similar to the one in the countries without them, the governments that were introducing the radical measures will certainly not do well at the election. Indeed, the governments of these countries locked themselves up in a strategy they cannot change anymore – they have to stick to it to the end.

The *hammer – dance – hammer – vaccine* strategy rests on the assumption that the second hammer (the harsh restrictions in the second wave) will give results. The assumption is valid if the hammer is strong enough, as can be seen in the model in Figure 6 (the right downward side of Risk A function). The fact that this group of countries had a lower mortality in the second wave than the middle group of countries and the countries with a low stringency index (except the Scandinavian group and Malta, where low mortality was probably caused not only by the measures but also by other factors) can be seen as evidence of the efficiency of very strong measures. The experience of Israel – a typical member of this group – is yet another evidence of it. Therefore, the *hammer – dance – hammer – vaccine* strategy makes sense if three conditions are met: (a) the government can provide a widely available and efficient vaccine; (b) reduction of COVID-19 risk is permanent (not just temporarily delayed mortality); and (c) reduction of COVID-19 risk does not substantially increase other risks (recall aggregate other risk B in figures above).

## HAMMER – DANCE – DANCE – END (VACCINE)

In autumn and winter, many countries, including Croatia, were confronted with the very strong second wave of the outbreak. The average COVID-19 mortality rate for the countries from the first *hammer – dance – hammer – vaccine* strategic group in the second wave by 4 February 2021 was 0.63 per mille. In Croatia it was approx. two times higher (1.22). In the extended group that, besides Croatia, includes Switzerland, Slovakia, Serbia, Latvia, France, Bulgaria, Belgium and Albania, the average mortality rate was 0.9 per mille. The difference is the average mortality toll paid for this strategy in the second wave, possibly also because of less stringent measures. This strategy makes sense if: (a) more stringent measures would not yield relevant results; (b) increase of other risks has been avoided; and/or (c) if the first strategy turns out to be wrong by the end of the pandemic due to a more rapid growth of COVID-19 death ratio than in the countries with the second strategy.

## WHICH STRATEGY IS BETTER

The critics of the *hammer – dance – dance – end (vaccine)* strategy usually assumed four things: first, that the excess mortality compared to the countries of the first strategy in the second wave is irreversible (they assumed that success in the countries of the first strategy was permanent); second, that the first strategy could be applied to the countries of the second strategy and yield the same results as in the countries of the first strategy (“Apply measures as Ireland or Germany and you will have the results as Ireland or Germany”); third, that there is no vaccine production and distribution-related risk that could cause duration of the second hammer with uncertain consequences; and fourth, that the spread of the outbreak cannot slow down further spread of the virus after a while. Time will tell how right they were about these reasons.

## BACK TO CHINA

Although China's radical approach to the fight against the pandemic has not been applied anywhere else, some European countries have obviously found both the reasons for and the ways of introducing very stringent lockdown measures. The process of "final analytical statement of accounts" takes time – at least several years of careful research and analyses that will explain differences in the dynamics and outcomes of the pandemic by countries. Europe offers a great sample of countries for such research – heterogeneous by its characteristics (stringency of measures, times of their tightening and loosening, and health outcomes).

China does not adhere to the European practice. No one has yet managed to come close to that country when it comes to the tightness and duration of lockdown, speed of recovery, health outcomes (the virus has "gone") and doubts in the official figures. Nevertheless, the China's case still attracts attention. Perhaps not as a role model anymore, like during the first wave, but certainly as a reminder of some unpleasant questions: Is there anything we have failed to do to curb the pandemic? Has the authoritarian China shown superiority over Western democracies in containing the virus? These questions do not concern the pandemic alone. In other words, we will better understand the pandemic if we place it in a broader context of the political and economic relations between the West and the advancing China.

## **PART 2**

# **CHINA AND DEMOCRACIES**





# CHINESE POLITICAL CAPITALISM AND ITS CONTRADICTIONS

## CHINA AS A LAND OF PARADOXES

China is a land teeming with paradoxes. The first big paradox is the fact that, although China is ruled by the longest surviving Communist Party in the world, the country's crucial economic features are nevertheless of capitalist nature. This is best described with the formula 60/70/80/90, comprising data for 2018: private sector's contribution to the total growth is 60%; it generates 70% of all innovations; it accounts for 80% employees in urban areas; it creates as much as 90% of new jobs (Zitelmann, 2019). The second big paradox is the coexistence of meritocracy and corruption. In her latest book *China's Gilded Age*, political scientist Yuen Yuen Ang from the University of Michigan calls China "corrupt meritocracy" (Ang, 2020). In China, both Party and state officials move up the political ladder if they meet objective indicators in managing the administrative units to which they were appointed. These indicators primarily include: increasing the rate of economic growth, employment and public revenue and maintaining social stability. Still, recent research of Professor Ang also showed that as much as 40% of Party leaders who had been investigated for corruption after Xi Jinping's arrival at the helm of the Chinese Communist Party in 2012 had been promoted to higher posts in the previous five years. This indicates that inequality in China is not only structural (e.g. inequality between rural and urban areas), but also – and to a larger extent – political. In this country, corruption is the most lucrative for those members of the elite who are in control of money flows; for example, high-ranking officials are more corrupt than the low-ranking ones and members of the Communist Party are more corrupt than non-members (Milanović, 2020).

This finding baffles all those who tend to define things by using simple classifications. This equally refers to the faction represented by the controversial

Canadian professor Daniel A. Bell (who primarily perceives the Chinese system as a political meritocracy, superior to the democratic principle “one person, one vote”) and to the faction that sees Chinese corruption as the cause of the imminent collapse of the Party. The line of thought of the latter faction is best reflected in the analyses by Minxin Pei, a U.S.-based Chinese professor.

The thesis on the existence of “corrupt meritocracy” should be incorporated into a more inclusive classification of the effects of corruption on the comprehensive social, economic and political development. Just like various medicines have various effects on the human organism, various forms of corruption have specific effects on the social fabric and economy (Ang, 2020). Corruption is always a form of social pathology, but not all sorts of corruption are equally bad. The predator corruption is reserved for the elite and implies grabbing of public resources (e.g. African kleptocracies). Petty corruption refers to the corruptive behavior of the members of the community who do not belong to the elite. One such example are low-ranking police officers who receive money for not fining those liable to pay fines. Both examples can be compared with medications with toxic effects and constitute the worst forms of corruption.

The third type of corruption is the money paid for “speeding up” processes by those who do not belong to the elite (such as storekeepers who bribe low-ranking officials to obtain work permits faster). This type of corruption functions as a painkiller: it temporarily alleviates pain but does not treat its cause. Finally, the fourth type of corruption emblematic for China is the “access money”. It functions like steroids. This type of corruption is reserved for the members of the business and political elite. It is characterized by obtaining political protection and privileged access to the market in return for money and strengthening of Party’s political base. Consequently, corruption and development are entwined and are both very competitive. Still, just like excessive use of steroids eventually leads to failure of organs, this type of corruption leads to failure of the political and economic modernization process. Xi Jinping’s China is an excellent example of this.

Conclusively, foreign observers should not become confused with the concept of “corrupt meritocracy” once they realize that the Chinese political system is hypercompetitive despite the absence of democracy and that the Party, directly or indirectly, controls access to economic resources. Political rise, particularly to the upper echelons of power (Central Committee and Politburo) is not possible without previous economic results. However, the imperative to

mobilize economic resources in the context of the omnipresent state control often leads to a trade of political power for profit between high-ranking Party officials and “red capitalists”. In the text below we will analyze in detail the effects of this process on China’s economic growth and political stability, but even this introductory part shows how complex China is and how its development trajectory defies the dyads “capitalism + liberal democracy” or “authoritarian capitalism + clean governance”. Despite all the complexity and fluidity of modern China, one should try to identify the essence of the Chinese model and describe its key features. The two following sections will help us with it.

#### WHAT IS BEHIND CHINA’S SUCCESS – MARKET OR STATE?

Trying to define the Chinese model is like chasing a mirage. Observers often become confused because they are trying to find in China’s development the confirmation of their pre-set views and preferences of the desired organization of political and economic life. Those who glorify the so-called “Beijing Consensus” primarily attribute China’s success to the strong state-intervention tools that the Party has retained in its hands, particularly when using state-owned enterprises as intervention levers. They also point out the state-run industrial policy and financial repression policy that the state uses to set the desired levels of foreign exchange rate and interest rates. On the other hand, those who identify with the Washington Consensus believe that maintaining the protection of private property, privatization program and price deregulation are the only factors responsible for China’s growth. But the story is much more complicated than this simple dichotomy; both of these narratives lie behind the rise of China, but to a different extent and depending on time and space.

The abovementioned political scientist Yuen Yuen Ang points out in her book *How China Escaped the Poverty Trap?* that China’s economic transformation initiated by Deng Xiaoping is best described with the concept of “managed improvisation” (Ang, 2016). As the architect of economic reforms, Deng left no dilemmas as regards China’s political transformation: China must be ruled by the Communist Party. His metaphor “bird in a cage” perfectly symbolizes the envisaged relation between private sector and the Party. If the cage is open, the bird will fly away (in other words: it will play the role of Western

merchants and industrialists during the transition from protocapitalist entities to liberal democracies with market economies). If the cage is too small, the bird will suffocate.

Regardless of certain aberrations in Chinese political and economic systems, which will be discussed in the next chapter, Chinese success in rapid reduction of poverty and in ensuring a swift growth primarily rested on its willingness to experiment and to accept local initiatives. Such a pragmatic approach can be described with Deng's sayings "We will cross the river by feeling the stones under our feet, one by one" and "It doesn't matter whether a cat is black or white, as long as it catches mice". Yuen Yuen Ang's research shows that, over time, many Chinese provinces and cities changed the division of tasks between Party and state bodies on the one hand and private sector on the other, thus having undergone transformations in the past four decades. In fact, during most of its post-Mao history, until Xi Jinping's arrival at the helm of the Party and the state, China imitated certain elements usually found in democracies and adapted them to its authoritarian political system. This primarily refers to encouraging competition and responsibility and developing instruments for division and transition of power.

At the beginning of Deng's reforms, the principle was that only the Party could ensure China's unity and stability and that it was possible only by retaining strict political centralization and avoiding multiparty elections. Still, Deng's reforms envisaged intensive economic decentralization which, in past decades, strongly encouraged mutual competition of provinces and cities. Exceeding the growth rate of the adjacent province was not an individual initiative of the local Party secretary; it was an approach introduced as a general standard in the society. Despite negative externalities like significant environmental pollution and periodical social protests provoked by usurpation of land use rights during the urbanization process, the model of economically decentralized authoritarianism resulted in an enormous growth. The introduction of responsibility towards Party bodies on upper levels, which insisted on tangible results, was an attempt to compensate for the absence of responsibility to the electorate between elections. And finally, the instruments of division and transition of political power were supposed to prevent a new Mao – an all-powerful individual who could repeat social disasters like Great Leap Forward and Cultural Revolution.

To this end, Deng introduced limited terms of office for Secretary General and his team in the executive power (appointed for two consecutive five-year terms by the Central Committee consisting of 205 members). He also introduced the retirement age for Party officials (they must retire after 68 years of age) and shifted the decision-making to the Politburo as a collective body, making the Secretary General *primus inter pares* and forcing various Party factions to align their opposing viewpoints when making decisions. Shifts on the centralization – decentralization power continuum often took place within such a context, which also resulted in strengthening and weakening of the influence of political patronage and co-optation system. It wasn't just responsibility and competition mechanisms that China borrowed from democracy textbooks; it also borrowed some less functional elements, particularly from less democratic and less stable democracies.

Some elites within the Party tended, and still tend, to expand their power network and maintain social peace by appointing clients and members of ethnic minorities to important positions. This is why the Party's declaratory goal to rationalize bureaucratic structures has often been in collision with the co-optation of elites and building and maintaining of a strong interest-based network. When Party secretaries in some provinces went over the top with corrupt behavior, bad loans on balance sheets of local enterprises and environmental disasters, the Party headquarters in Beijing restrained their power by organizing anticorruption investigations and trials and by activating intervention tools. After the damage has been undone, control mechanisms loosen up again and things can go back to normal, increasingly relying on market mechanisms and a growing share of private sector in national production, until this process begins to erode the foundation of the Party power again.

Everything said above can be seen as additional evidence that China's rise after its post-1978 opening and reforms cannot be described as a linear trajectory that was supposed to lead to full-scale political liberalization driven by economic liberalization. The economic pendulum kept swinging between intervention and market tools. In some periods and regions there were more market reforms and less corruption, while other times and regions were characterized with dominant inefficient state socialism and thriving corruption. Sometimes, market failures such as numerous frauds and foodstuff scandals would dominate and sometimes – even more often – state failures such as neglect for environmental protection and the protection of workers' rights. The

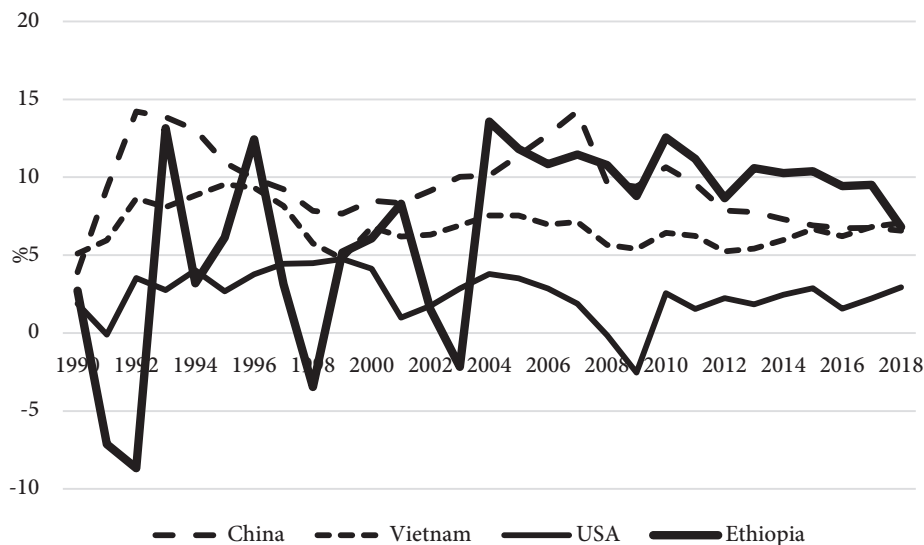
state was successful in dealing with some market failures by providing public goods like first-class roads and railways and almost full-scale price deregulation and mass privatization stimulated the almost dormant market.

Still, despite the abovementioned enormous adaptability and elasticity of the system, there are certain constants in China. As focusing on the “managed improvisation” concept could result in a situation where the number of questions raised exceeds the number of answers given, the next section will focus on the concept of political capitalism which best describes what present-day China is and what it is not.

#### POLITICAL CAPITALISM AS THE ESSENCE OF THE CHINESE MODEL

After the fall of Berlin Wall in 1989, capitalism was the only game that remained in the global village. To a bigger or lesser extent, the whole world started organizing production by using the fundamental organizing principles of capitalism: increasingly relying on private ownership of capital as means of production; voluntary exchange of paid labor in the increasingly global labor market; and production relying on decentralized coordination and motivated by profit. Despite numerous versions of capitalism studied in a separate segment of political economy entitled “Variants of Capitalism”, the acclaimed Serbian-American economist Branko Milanović thinks that, after the end of Cold War, two typical versions of capitalism emerged on the global level (Milanović, 2019). The first version is the liberal-meritocratic capitalism embodied by the United States, Japan, Canada, Australia and the European Union. Most of the production in it is concentrated in the dynamic private sector; it is based on free multiparty elections and respect for human rights and enables promotion of gifted individuals by providing increasingly inclusive access to education and enabling market evaluation of their extraordinary results. Opposite to liberal-meritocratic capitalism is the political capitalism applied primarily in the People’s Republic of China, but also – in its local variants – Russia, Vietnam, Myanmar, Algeria, Ethiopia etc. The common traits of these countries include high economic growth rates (regardless of long-term consequences of the often unbalanced growth), substantially limited civil and political rights of their people and generally low level of institutional development (Figure 7 and Figure 8).

*Figure 7 GDP growth rate in the U.S. and in three countries  
with elements of political capitalism, 1990-2018*

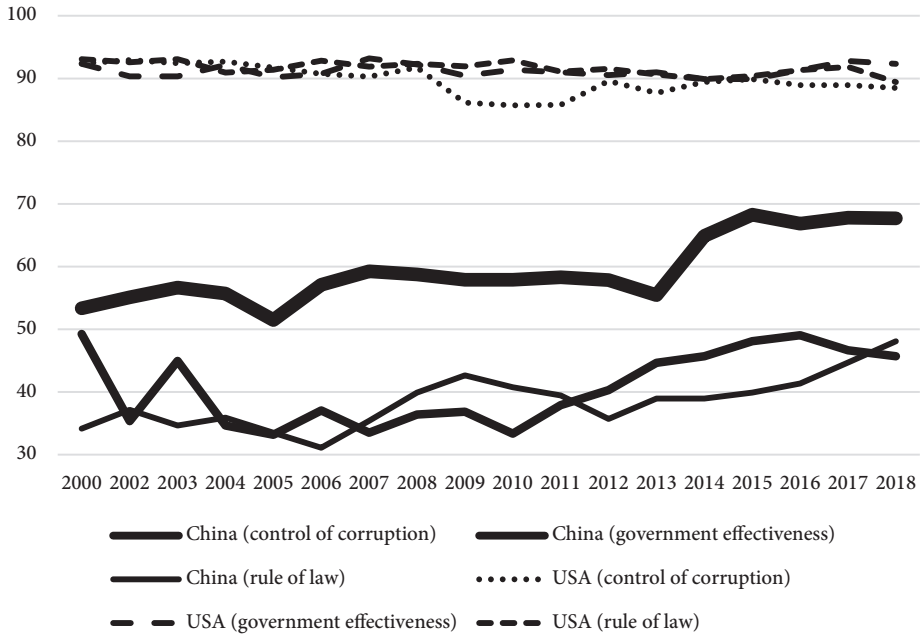


Note: The differences between the lines should be interpreted as illustrative statistical facts, not track records of success, because higher growth rates are expected in less developed countries.

Source: World Bank, 2020a

Of course, the most powerful and most efficient incarnation of political capitalism in the world today is the People's Republic of China. Political capitalism in China has three distinguishing features:

- 1) State and Party structures relatively resistant to the pressure of business and civil society which, due to the imperative of efficiency and expeditiousness, often ignore the need for legal and moral limits and the necessity of achieving democratic compromises.
- 2) Absence of rule of law which enables the ruling elites to apply law selectively, particularly against rival factions and political opponents.
- 3) Competent and efficient bureaucracy which owes its legitimacy to the high economic growth rates that it generates.

*Figure 8 Quality of institutions in U.S. and China (in percentiles)*

Source: World Bank, 2020b

Despite impressive achievements of the Chinese model of political capitalism, such as pushing dozens of millions of people to the global middle class status and extracting some one hundred million others from extreme poverty, its system has two fundamental contradictions. First, the tension between the system's first and second features – technocracy-oriented bureaucracy and loose rule of law – generates enormous corruption which is embedded in the genetic code of political capitalism. Adding to this tension is the fact that the modern state in China appeared much earlier than the civil society, compared to the state development trajectory in the West. In such an environment, traders and entrepreneurs could never have a crucial influence on political decisions; their activities would be tolerated as long as they did not threaten the political primacy of the emperor and the Communist Party today. Second, corruption adds to economic and political inequalities. Such corruption is endemic in a system where state bureaucracy and Party organs can use power at their discretion and control access to economic resources. Also, for a system to maintain legitimacy, it must contain the uncontrolled growth of inequality. Acclaimed



economist Albert Hirschman wrote about the changing tolerance for the growing income inequality in various stages of economic development. In the early stage of development there is a large tolerance for growing inequalities between various groups, sectors and regions because of widespread expectation that the disparities will one day diminish to their benefit. Such an approach is pragmatically incorporated in Deng's saying: "Let some get wealthy first".

If an escalator had an exclusive fast lane and another one intended for everyone else – which is out of order – the tolerance for this disparity will be radically reduced. We should mention here that, at present, the wealth of the 153 richest members of the Chinese National Congress is estimated to over USD 650 billion (Wee, 2018). In order to avoid such an undesirable scenario that could pose a threat to the Party, the system has been organizing regular anticorruption campaigns in order to maintain the delicate balance between corruption and growth. But the condition was that this process should not affect the basic tenets of the system, such as collective decision-making and regular transition of power, the lack of which has been the nemesis of numerous authoritarian regimes to the present day. These tenets may have not necessarily predestined China to be a global hegemon and the world's most developed country, but has certainly made it a real exceptional global player.

## XI JINPING AS THE LEADER OF THIRD CHINESE REVOLUTION

After Xi Jinping became head of the Party in 2012, China's economic and political pendulum swung towards the rigid political capitalism and authoritarianism unprecedented in post-Mao China. If the triumph of Chinese Communist Party was the first revolution and Deng's opening and liberalization reforms (that marked the beginning of the all-powerful totalitarian state's gradual withdrawal from the social sphere) were the second one, then Xi's arrival can be seen as the third revolution – the intention of which was to introduce the invasive state's comprehensive control over the society (Economy, 2018). Such course of events is possible with the help of extensive use of sophisticated digital surveillance and facial recognition technologies, enormous increase of the role of state in economic processes and insistence on the population's dedication to the concept of "Chinese dream", which is supposed to reconcile the growing prosperity of individuals with China's future role as a global leader.

Before Xi Jinping's era, despite all of its imperfections such as corruption and the abovementioned negative externalities, Chinese regime managed to find enough room for ideological flexibility and political pragmatism. That was possible owing to the already discussed collective decision-making model and limitations for the extreme concentration of political power in the system. Xi Jinping replaced this system with totally centralized political decision-making and he also abolished both the unwritten and the written rules that had regulated transition of power (such as a ten-year limit for the term of office of General Secretary).

In the beginning, Xi managed to disguise his political agenda with the anticorruption investigations supposed to stabilize the system but, with the passage of time, Xi's revolutionary agenda and desire to eliminate political opponents became increasingly obvious. This transformation had a paradoxical effect on decision-making, as can be seen from the early stage of the coronavirus outbreak. In the system where all the eyes look at the powerful leader and where low-ranking officials are afraid of making decisions that could trigger his retaliation, there is always a decision-making bottleneck because even the most powerful and shrewdest leader acts in the conditions of limited rationality and time.

Instead of ideological flexibility such as the gradual co-optation of entrepreneurs into the Party ranks (the creation of "red capitalists") that took place when Jang Zemin was General Secretary, Xi's era has been marked with ideological rigidity. The earlier trend of entrepreneurs entering the Party was replaced with the trend of Party entering the enterprises. In 2012, only a few companies quoted at Shanghai and Shenzhen stock exchanges had articles of incorporation that stipulated the forming of Party cells in the company and their influence on the decisions of the management. By late 2017, more than 300 out of 3,314 companies had introduced changes to this end (Nakamura, 2017). This trend has mostly been recorded in state-owned enterprises. In 2019, for the first time, there were 119 Chinese companies among Fortune Global 500 when it comes to operating income, but the share of Chinese state-owned enterprises in the Chinese contingent had grown from 76.3% in 2018 to 80.2% in 2019 (Zheng, 2019). After the coronavirus outbreak, this process gained additional momentum. In September 2020, the Communist Party's Central Committee issued a document entitled *Opinion on Strengthening the United Front Work of the Private Economy in the New Era*. According to Ye

Qing, vice-chairman of All-China Federation of Industry and Commerce, this document should entitle Party cells in companies to control the decisions on human resources in private companies, as well as internal audits and behavior of individual employees (Livingston, 2020). In addition, Xi Jinping's highly-publicized visits to several state-owned enterprises in summer 2020 clearly signalized the Party priorities.

Private companies are still welcome because the Party wants their innovation potential and growth. There is no doubt, however, that the politically controlled strategic industries will continue to be the core of the economic system with Chinese traits. Such a course is rooted in the strong desire for their internationalization and self-sufficiency in key technologies such as telecommunications and artificial intelligence (China Briefing, 2020). American moves such as Trump's putting Huawei and similar Chinese companies on the U.S. Department of Commerce list of entities for which American exporters require permits when selling important technological components, only sped up the swinging of the pendulum towards Chinese version of state capitalism 2.0.

Even before the corona virus outbreak, mass campaigns of forced indoctrination and increasingly brutal repression against ethnic minorities and political opponents were taking place. The pandemic intensified this trend: illustrating the spirit of the new repression era, the elite Fudan University recently deleted "freedom of thought" from its charter, while "academic independence" gave way to "patriotism and loyalty to the Party" (Fifield, 2020). The increasingly tight control over the society is symbolized not only by the intended full-scale application of the national social credit system that will rank the population by desired behavior (among other things, points are earned for meeting contractual obligations and studying Marxist-Leninist ideas and are lost for traffic violations and "unfounded" criticism of the Party course – a full-scale application of digital authoritarianism). The growing trend of the Party's control of the society is also reflected in the number of registered Party cells across China. In 2013 there were 4.3 million of them and in late 2018 there were 4.6 million (Grünberg i Drinhausen, 2019).

In foreign policy, Deng's mantra "Hide your strength, bide your time" was replaced with an aggressive foreign policy towards neighboring countries and those who do not share China's views. No wonder that these new circumstances gave rise to Chinese nationalism, which is increasingly being used as a means of the regime's legitimacy. Xi's key foreign policy initiative, Belt and

Road, launched in 2013, fits perfectly in it. One of the goals of the initiative is to win over as many countries as possible and allure them to China's sphere of interest.

Finally, despite the already mentioned shortcomings of the Chinese political capitalism before Xi's era, China was on the way of gradual political and economic liberalization, although the Party had never considered allowing free and competitive elections. We can safely say that China was on the way to an imperfect version of the Singaporean model that implied the political monopoly of the ruling party in a prosperous and partly free capitalist society. Obviously, during the period of opening, China could not deal with the problem of corruption in the Singaporean way because of its size, so the virus of corruption embedded in the Chinese political capitalism prevented full-scale development of Chinese potentials. Unfortunately, in the past seven years of Xi's rule, the Chinese regime has become something completely different as compared to the post-Mao period. The regime lost its important feature of anti-fragility that Nassim Nicholas Taleb writes about and has become less stable in the long run (Taleb, 2012). And finally, strengthening of the role of the state in the economic processes in 2013 instead of the expected and announced liberalization would additionally underline China's contradictions hidden in the already described concept of "corrupt meritocracy".

Despite the proclaimed fight against corruption, that has so far been used to consolidate Xi Jinping's political power, the growing state control will potentially usher in even more corruption. In this scenario, it is easy to imagine a cycle of political centralization under the pretenses of fight against corruption. This will make the regime even more fragile. Because of this trend and because of some other economic and political limitations that will be discussed in the next chapter, China will not be able to become the global economic and political leader after the corona crisis, but will nevertheless present a huge challenge for liberal democracies.

## CHINA'S VULNERABILITY BEHIND THE ILLUSION OF STRENGTH

Soon after Chinese authorities had announced the triumph over the virus in Wuhan, the city where it first appeared, heated debates about China's new role in the global economic recovery took place around the world. Since the rest of the world is still making significant epidemiological efforts to reduce the COVID-19 death-rate trend to an acceptably low level and since China is the only G-20 economy that recorded economic growth in 2020, a narrative has been imposed which presents China as a new locomotive of global growth in the post-corona era.

The second thesis, which closely draws upon the first one, discusses China's move to use the initially poor Western liberal democracies' response to the pandemic outbreak to strengthen its central position in the global economy. With anxiety or enthusiasm (depending on their place in the political spectrum), many commentators started talking about the onslaught of Chinese authoritarianism and the resulting weakening of Western liberal democracies. This chapter will show that China is a strong power and economy but that it is much more fragile than it is dominantly perceived from outside.

### NOT EVERYTHING IS GREAT IN THE PERCEPTION OF CHINA AS A LOCOMOTIVE OF GLOBAL GROWTH

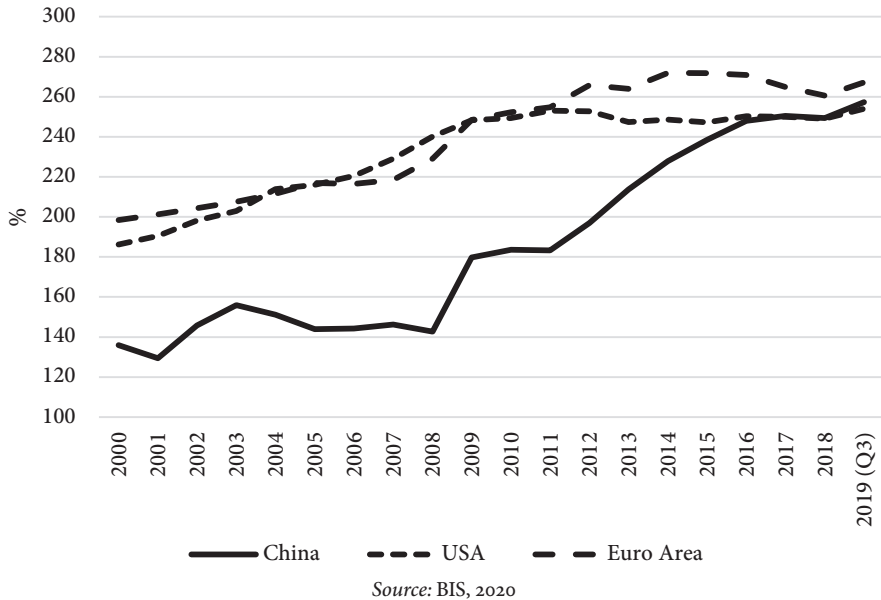
In the debates on China's capacity to respond promptly to the initially plummeting economic activities, the analogy of the last crisis before this one – that of 2008 – is often used. After the collapse of the Lehman Brothers investment bank in September 2008, the Party headquarters in Beijing wasted no time. Soon after the financial shock that shook the world, China announced a fiscal stimulus of dizzying 12.5% of GDP, which accounted for a percentage share in Chinese GDP three times that of the equivalent US package (Wong, 2011). If we add to this the increased credit activities prescribed by Beijing to the banks

that were mostly state-owned, the overall stimulus amounted the unbelievable 27% of GDP. With the help of this financial bazooka, China was the first one to avoid the aftermath of the global financial tsunami. The growth rate in the first quarter of 2008 was 11.5% compared to the first quarter of 2007, and the growth in the first quarter of 2009 was 6.4%. For the sake of comparison, the growth in the first quarter of 2019 was 6.4% and the one in the first quarter of 2020 was -6.8% – the worst drop of GDP in China’s modern history (Lardy and Huang, 2020). Many will just dismiss this data and point out that the sharp drop of GDP will have an effect analogous to plucking a guitar string: the bigger the drop, the faster the recovery and growth.

And yet, despite the 2.3% growth of Chinese GDP in 2020, the Chinese economic imbalances became even more pronounced and the maneuvering space for efficient dealing with some future recessions became substantially smaller. Figure 9 shows how, after 2008, the overall debt of Chinese non-financial sector grew from 140 to almost 250% of GDP before the pandemic. Following the abovementioned trend, the overall debt of Chinese non-financial sector was, according to Bank for International Settlements (BIS), 258.8% of Chinese GDP in the fourth quarter of 2019, while in the third quarter of 2020 it exceeded 285% of GDP. At the same time, the debt of the non-financial sector of Euro Area and U.S. reached 288.5% and 290.2% of GDP, respectively. As regards the long-term trend, the assets of the China’s banking sector are almost 5 times bigger than in 2008, accounting for as much as half of the world’s GDP in 2020 (Kynge, 2020).

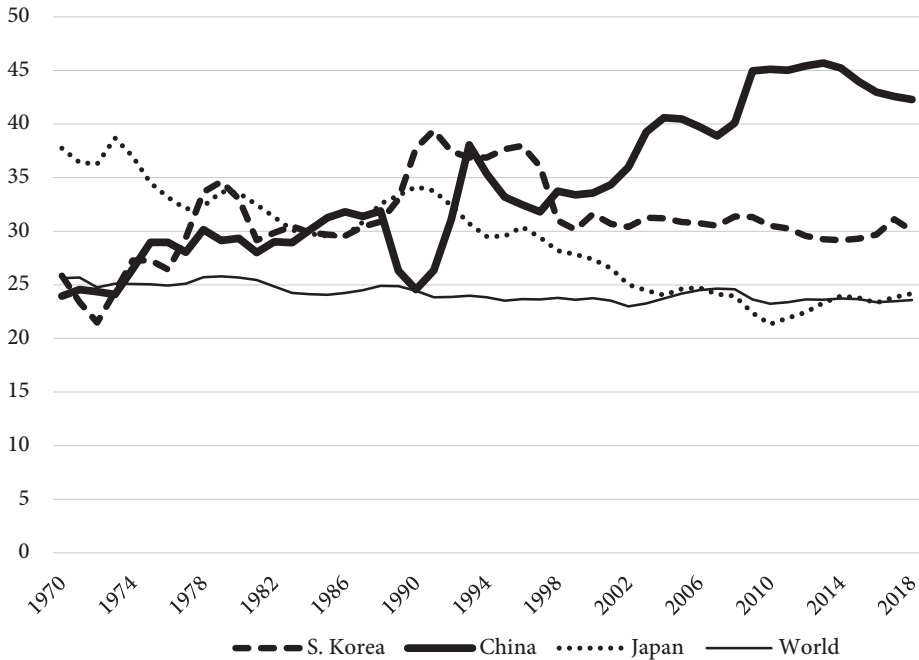
In the present-day circumstances, China’s debt is the highest among the fast-growing economies and its overall debt is growing much faster than its economic activities. According to a Rhodium Group analysis, the additional increase of debt serves primarily for repayment of the interest on the debt accumulated after 2008. An additional challenge for debt sustainability lies in the devastating development of the incremental capital output ratio (ICOR) that measures the ratio of investment rate and growth rate (lower ratio implies higher efficiency). Before the global financial crisis of 2008, ICOR ranged below 4. In the past decade it recorded a fast growth and, since 2016, it has ranged between 6 and 7 (Figure 10). This means that Chinese economy needs 6-7 investment units in order to generate a single unit of GDP (Wolf, 2018). In this context, China’s problem is not the fact that it opened the credit taps in 2008, but the fact that it did not know how to close them – or, better, did not want to close them.

Figure 9 Overall credit to non-financial sector (in % of GDP)



After Xi Jinping took control of the Party in 2012, all the attributes of the political or state capitalism have become visibly stronger, as we explained in the previous chapter. If, after joining WTO in 2001 and launching massive privatization managed by the then prime minister Zhu Rongji, China welcomed the development of private entrepreneurship and private investments as a motor of growth, the past few years saw a dramatic turn. Chinese state-owned enterprises have been given increasing access to credit, despite the fact that private companies had over time become increasingly successful in terms of RoE (return on equity) and RoA (return on assets) as standard measures of business success. At the same time, in the past decade, the RoE of state-owned enterprises dropped almost by half. These developments surprised even acclaimed China scholars such as Nicholas R. Lardy of Peterson Institute for International Economics in Washington DC, who in 2014 published his book *Markets Over Mao*. In this book he explains how market forces were the key factor behind China's success and that this success cannot be explained only by state's control over "economy's commanding heights". He also showed that the role of state-owned enterprises in the economic process had not been strengthened in the decade of Hu Jintao and Wen Jibao.

Figure 10 Gross investment in fixed capital (in % of GDP)



Source: World Bank, 2020a

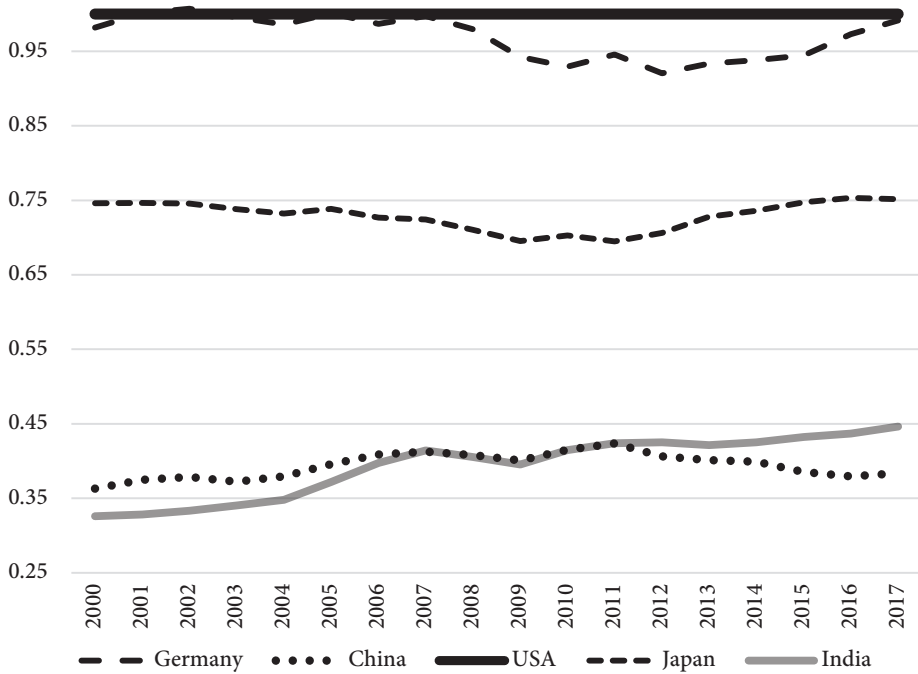
But only five years after that book, Lardy wrote a new one, *The State Strikes Back*. In it he says that the crucial reason for China's economic deceleration in the past years was the absence of liberalization and privatization in the sectors where state-owned enterprises operate. In addition, their already existing bear-hug around Chinese economy gained additional strength. Actually, this trend is not in keeping with the conventional picture of political capitalism which shows China's inhabitants as voluntarily accepting high growth rates in return for giving up political freedoms and accepting the authoritarian system. The moves Xi Jinping has made so far indicate that the key priority of the Chinese leaders is not higher growth; their ultimate goal is to maximize the level of political control. In this respect, it is not that Xi Jinping is not aware of the advantages of the implementation of structural reforms and privatization; he simply has a different agenda. The emphasis that he lays on control instead of competition leads to economically suboptimal policies, such as centralization of political power, strengthening of inefficient state-owned enterprises



and controlling the Internet. Paradoxically, such an approach is slowing down the decision-making process in a large and complex system such as China's and it reduces growth rates in the short run, but is nevertheless tolerated and promoted due to current Chinese leadership's desire to increase the level of political control by using strategic investment, independent of economic logic.

Lardy's analysis underlines such a conclusion with a calculation that the growth of Chinese GDP would be higher by at least two percentage points if liberalization and privatization took place in the sectors dominated by state-owned enterprises (power industry, telecommunication, banking, shipbuilding). Figure 10 shows that Japan and South Korea, as the only two non-Western economies that have managed to avoid the middle income trap, not for a moment in their swift development did they have such a level of investments as China has had in the past 15 years. Figure 11 shows the law of diminishing returns arising from such an approach. The total factor productivity (the portion of growth not explained only by growth in inputs of labor and capital) is significantly lagging behind the world's most developed economies and has been dropping in the past years. Considering its high debt and the law of diminishing returns in using an extensive investment strategy, China has not solved its fundamental dilemma; it has merely postponed it for the future. And the dilemma is: Should the economic growth be supported in the short run by continued accumulation of debt or should a somewhat higher growth be sacrificed in the short run in order to rid the system of bad loans and thus pave the road to long-term sustainable high growth rates? The latest developments suggest that the Party has once again chosen the "drinking poison to quench thirst" approach in order to retain a high degree of political control. Instead of carrying out the structural reforms which are to be discussed in detail on the pages below, the Party once again decided to "uphold" the growth curve by opening credit taps. These moves have definitely frustrated China's ambition to occupy the central position in global economy sometime soon. Besides, such efforts have been facing not only economic limitations, but primarily the political limitations arising from Chinese political economy of reforms, of which more will be said in the following section. But before we move to the crucial discussion about the political limitations of growth, we must first explain in detail the economic limitations – in other words, the internal and external economic imbalances encumbering China.

*Figure 11 Total factor productivity compared to USA (=1),  
as against constant purchasing power parity*



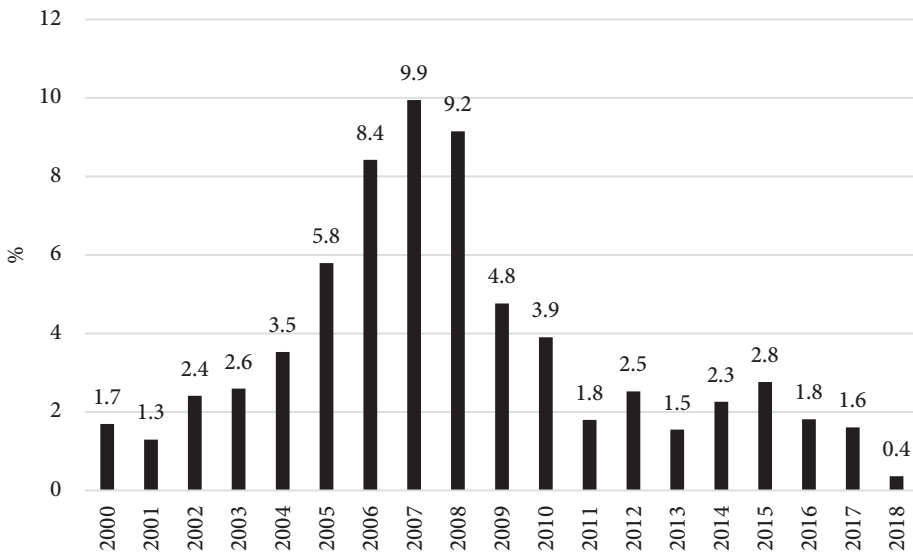
Source: Feenstra, Inklaar and Timmer, 2015

#### EXTERNAL AND INTERNAL IMBALANCES IN THE CHINESE GROWTH MODEL: CORONA CRISIS CONSOLIDATING THE STATUS QUO

After the global financial crisis, China reduced its external imbalance in the form of a huge current account surplus, generated with the help of an aggressive economic policy (controlling foreign exchange rate, interest rates and price of labor) in the period between 2004 and 2009 (Figure 12). After several successive years of relying on this growth model, the rest of the world could simply not absorb the growing surpluses of this enormous and fast-growing economy, so China had to discover new sources of growth. Together with the reduction of external imbalances, a gradual increase of internal imbalances as part of an extensive investment strategy took place. This transformation was additionally accelerated by the global financial crisis and Trump's protectionist policy. Still,

despite the intention to rely increasingly on the development of the domestic market, proclaimed also by the earlier Party leadership (Hu Jintao and Wen Jibao) after they had publicly claimed that China's growth was "unbalanced, uncoordinated, unstable and unsustainable"), that never materialised – neither before nor after the pandemic outbreak. Even before the corona crisis it was clear that China was simply too big for the rest of the world and that it could not rely on the growth fueled by export, like Japan, South Korea and Taiwan in the golden period of their economic transformation. This problem was additionally articulated in early 2021, when it became clear that China's recovery had been fueled by the growth of industrial production, state investment and net export. In 2020, China's current account surplus was USD 330 billion or 2.2% of GDP (Chimits, 2021). One could say that it was foreign demand that incited China's recovery, while Chinese domestic demand hampered growth in the rest of the world. At the same time, China faced growing political resistance in the rest of the world, particularly after trust in its institutions and good intentions had been considerably shaken as a result of its aggressive foreign policy.

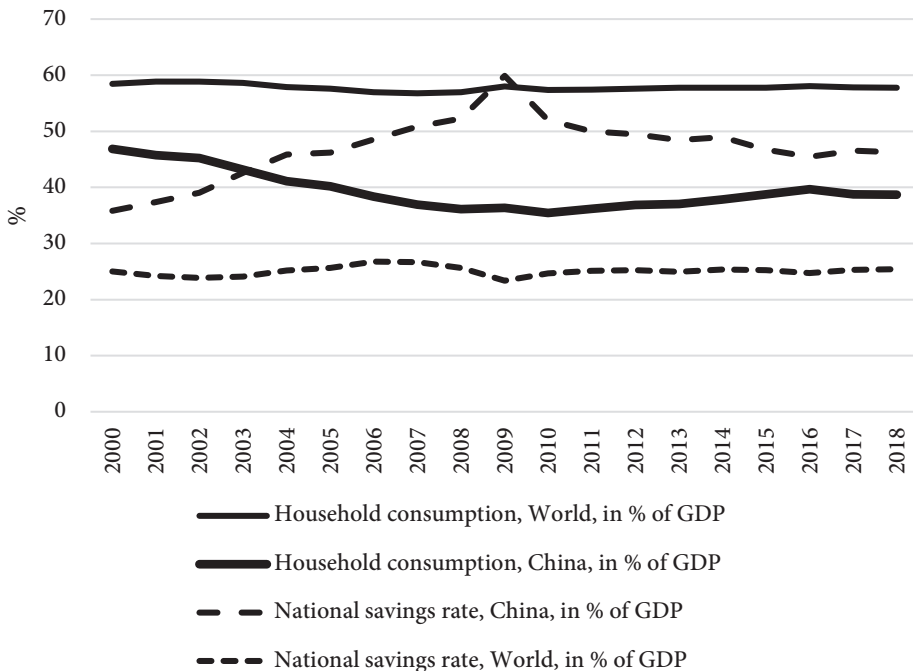
*Figure 12 China's current account surplus (in % of GDP)*



Source: World Bank, 2020a

Chinese internal imbalances are not made up only of fast growth of the total debt, low investment efficiency and misallocation of capital. Present-day China has much more square meters of housing per capita than most of the developed countries; more than one fourth of these square meters are not in use and real estate and construction sectors account for 12-15% of GDP (Turner, 2015). The imbalances are but a mirror image of the lack of development of domestic personal consumption. Figure 13 shows how low household consumption as a component of China's GDP is when compared to the global average. The difference is even bigger when compared with developed economies. While the level of household consumption is low, the national savings rate is high – since the beginning of this millennium it has never accounted for less than 45% of GDP. The savings of household sector account for more than half of these savings.

*Figure 13 Household consumption and savings as % of GDP, China and world*



Source: World Bank, 2020a

There are two reasons for this structure of savings. One is the fact that people save money out of precaution and the other is demographic change. As

much as these two explanations may seem opposed, they are complementary because both of them are rooted in the very rudimentary system of Chinese social transfers. Such a system motivates households to take precautions against risks such as poor health, injuries, old age or unemployment. This is particularly reflected in the very low level of public health expenditure; it accounts for less than 2.5% of GDP in China, as compared to more than 6.5% in the OECD economies (Robertson, 2020). Illustrative of the shortcomings of the Chinese health-care system, which combines the worst elements of both private and public system, is the fact that, according to WHO, China loses 40% more years of productive life per 1,000 inhabitants to diabetes, injuries and neurological and cardiovascular diseases than the United States (Beckley, 2018). As for the Chinese pension system, it is very fragmented by provinces. The lack of homogenous and strong national pension system makes it hard to deal with the risk of old age which is expected to grow in the decades to come, given the markedly negative demographic trends (Figure 14).<sup>2</sup> Despite the 2.3% growth of Chinese GDP in the pandemic-stricken year, the number of newborns in China dropped by as much as 15% in 2020. COVID-19 will additionally exacerbate the problem of rapid ageing of China's population (Hale, Yang and Yu, 2021).

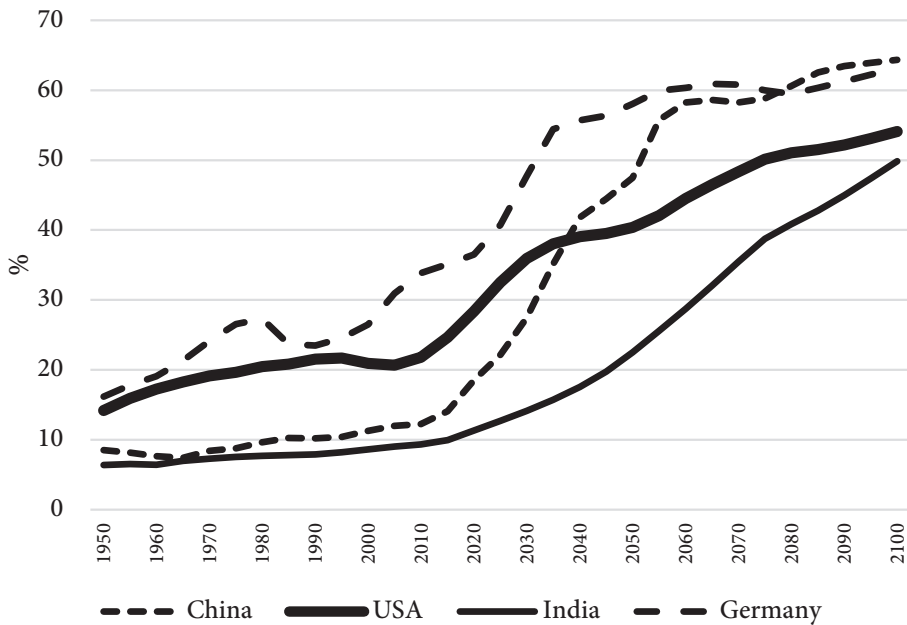
The unfavorable structure of GDP described above has been additionally disturbed during the COVID-19 pandemic. Between 2018 and the outset of the pandemic, the retail trade grew faster than the industrial production, which resulted in an increasing orientation to a growth based on domestic consumption (regardless of the very low initial level at which this growth began). The pandemic reversed this trend: as of January 2020, the industrial production has been growing much faster than the retail (Pettis, 2020b).

In China, sustainable economic recovery primarily requires the recovery of demand, which will then give a pull to the growth of supply. Still, the Party decided to invert this logic and lay great stress on the growth of supply in order to achieve short-term stabilization of employment. However, such an approach resulted in a great loss of income of migrant workers – as many as USD 100

<sup>2</sup> The risks connected with ageing will become even more prominent in the future because, according to the UN projections, the share of Chinese population above 65 years of age will be almost 30% (410 million) in 2055. For the sake of comparison, in the United States this share will remain 20%. In the case of China, such a trend will increase the erosion of human capital. This will have negative effects on the future productivity, in addition to the already mentioned challenges in the health care system.

billion (Chorzempa and Huang, 2021). Due to lack of transparency in calculation of the official unemployment rate, it is hard to establish the effects of the pandemic on the labor market. Although the official unemployment rate in December 2020 was 5.2%, just like the year before, the fact is that 149 million self-employed company owners and almost 300 million migrants were not included in the rate (Peach and Leng, 2021). This is why it is hard to believe the official numbers; a large percentage of the self-employed and migrant workers work in service trade, a sector definitely bypassed by the recovery, which is a great internal imbalance that China is facing.

*Figure 14 Dependency ratio of the elderly population: number of people aged 65 and over compared to number of people aged 20-64*



Source: UN, 2019

## STATE CAPITALISM 2.0: HOW THE STATE CAPITALISM FLOOD SANK THE AMBITIONS OF JACK MA

While the previous section paid more attention to the economic limitations that the vision of China as a locomotive of global growth was facing, this section will immerse much deeper and introduce the political limitations into the process. Despite the enormous concentration of political power in the hands of Xi Jinping, we can still describe China's political system as "fragmented authoritarianism". State-owned enterprises, local authorities and well-networked private companies form a strong and extended network of interests which is hard to govern from a single center (the system is too complex and too big). By way of illustration, in 2019, a hundred or so biggest state-owned non-financial enterprises paid to the state budget only 2.4% of their net-profit, although it was announced as an official goal way back in 2013 that state-owned enterprises should pay to the state budget 30% of their net-profit (Huang, 2020). This supports the thesis of Eswar Prasad, professor of economics at Cornell University, that Chinese state-owned enterprises have become a channel for accumulation of wealth for the economic and political elites. So, there are two harmful aspects of this situation. Not only that state-owned enterprises are a millstone around the neck of economic growth due to widespread corruption and generation of high economic rents, but they also fail to pay part of their profit to the budget in order to create a more sustainable and more balanced political-economic structure that would fit into the official vision of a "harmonious society" or "Chinese dream". The specific interest groups emerging in such a network are impossible to eliminate, but their maneuvering space can be reduced.<sup>3</sup> In this respect, we can say that Xi Jinping managed to tighten control over the system much more than his predecessors, primarily in order to maximize his own power, but he did not use the power thus acquired to

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<sup>3</sup> The Party and state-owned enterprises are in symbiotic relationship, but they still have to solve their conflicts from time to time, when their interests are not fully harmonized. On the highest level of power, the Party ensures favorable legislation and financing, but insists on controlling hiring policy in state-owned enterprises. Also, such enterprises have substantial autonomy in developing their business plans, which is when corruption and inefficiency grow due to soft budget constraint. This is tolerated as long as the managers stick to the official Party line and as long as their actions do not threaten Party's legitimacy and its political control.

carry out the necessary reforms (otherwise he would make powerful enemies in the Party ranks).<sup>4</sup>

After the pandemic outbreak, Xi Jinping only reinforced this agenda. We could call this state capitalism 2.0. It is best illustrated with what happened to Jack Ma, probably the best known Chinese worldwide and, according to many, a Party member since early 1980s. But neither was of any help to him when the biggest initial public offering of the stocks in history was cancelled. But before going into the details of this story, we will just say a few things about the developments in the sector of Chinese state-owned enterprises and in financial institutions. For this we will use the available data for the first half of 2020 in order to provide a context for the story of Jack Ma and Alibaba's (Ant Financial) failed IPO.

The crisis caused by the pandemic additionally intensified the problem arising from the state-owned enterprise system. The present form of their organization will threaten the sustainability of high economic growth rates in the long run. In the first half of 2020, the share of bad loans in Chinese banks of almost all categories increased. Largely contributing to it were the non-profitable state-owned enterprises whose total number – together with cumulative amount of loss – has continually grown in the past decade (Huang, 2020). The Party will certainly respond to this challenge by initiating a new round of politically sponsored mergers and acquisitions and by attempting to rid the corporate sector of its debts in a controlled way in order to avoid any major bankruptcy incidences. Maintaining stability remains the key imperative, but the question is for how long will this stability be attainable in the long run, as the Chinese economic recovery has brought to light old structural problems such as excessive credit intensity of economic growth. As a case in point, Chinese GDP quadrupled in the period between 1980 and 2010, but the level of debt was low and the dynamics of its growth was slow. Contrary to that golden era of Chinese growth, the period between 2010 and 2020 saw doubling of the GDP, but also trebling of China's total debt to USD 43 trillion (exceeding 280% of GDP in late 2020). If the ratio of debt and GDP growth remained as it is in order to enable doubling of the GDP by 2035, the total Chinese debt would ex-

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<sup>4</sup> In addition to achieving his own political ambition, such move gives him more flexibility in managing the economy in the short run, which became particularly visible after the 2015 Shanghai stock exchange crash and the ensuing capital outflow that took place despite the strong capital control system that was in place.



ceed as much as 400% of GDP (Pettis, 2020a). Keeping in mind this particular problem and the growing geopolitical tensions between China and the U.S., the Party has decided to tighten control over the accumulation of private capital and impose a political agenda to it.

Expecting that strict political control can boost technological progress is an illusion, which is best described with the words of billionaire and entrepreneur Jack Ma himself: “To innovate without taking risks is to strangle innovation. There is no risk without innovation in the world. Very often, an attempt to *minimize risk to zero* is the biggest *risk* itself” (in Mitchell et al., 2021). But soon after he said these words at Bund Summit in late October, the initial public offering (IPO) of Ant Financial shares that was supposed to raise USD 34 billion, thus exceeding Alibaba’s historical record of USD 25 billion, was suddenly cancelled. The Party top brass were not very fond of the idea of Jack Ma trying to top himself; rumor has it that Xi Jinping personally intervened and demanded that the IPO be cancelled. Two months after Jack Ma’s was last seen in public, the Chinese State Administration for Market Regulation (SAMR) launched an investigation of Alibaba’s monopolistic practices, such as the requirement that the traders using Alibaba selling platform sign exclusive contracts with it. The same agency wasn’t that diligent in launching identical investigations of problematic practices in the sector of state-owned enterprises where megamergers continued in 2020, despite the corona crisis. The best example is the USD 146 billion worth merger of SinoChem and ChemChin. The logic behind this discriminatory practice is very prosaic – if state-owned enterprises pull it off, so will the Party, both economically and politically.

The real sin of Jack Ma and Alibaba is what the Party in its newspeak calls “disorderly expansion of capital”. Political monopoly, as Communist Party sees it, authorizes it to determine what constitutes public good, so there is no reason why companies should seek private profit instead of achieving the goals imposed from above. In the past months we have witnessed an open political criticism of Alibaba’s and Tencent’s focus on “some greens and a few kilos of fruit” instead of having Chinese “Internet giants with huge access to data and with advanced computing assume greater responsibilities, higher aspirations and a more important role in the country’s scientific and technological progress” (Freedman, 2021). Thus, unlike recent actions of the European Commission and the U.S. Senate, indicating that the moves of the FAANG<sup>5</sup> are criticized be-

<sup>5</sup> Facebook, Apple, Amazon, Netflix and Google.

cause of their impact on the very foundation of the democratic order, Chinese Communist Party has no problem per se with accumulation of capital and monopoly power. On the contrary, the problem exists when there is accumulation of capital outside the innovation agenda imposed by the Party. A clear message was sent to Chinese billionaires, many of whom are Party members: You are not owners, but caretakers of the Party wealth. It seems that Chinese leaders are probably right in believing that tightening control over private sector will probably strengthen their political position in the short run. But in the long run, the biggest victim of the Party's alleged anti-trust agenda will be the very same monopoly that they are trying to save – the Party's political monopoly and its aspirations to become the world's hegemon. Regardless of Party preferences, China cannot become the world's hegemon without creative destruction and growth of a strong middle class – which is the subject of the next section.

#### MIDDLE INCOME TRAP AND THE FORGOTTEN CHINESE

After World War II, many countries quickly managed to reach the middle income status according to the World Bank classification, but very rare were the ones like Japan and South Korea that managed to avoid a sharp drop of productivity and substantial deceleration of growth before joining the club of high-income countries (Agénor et al., 2012). Those who failed to do it fell into the middle income trap. China is definitely facing the same fate. It could avoid this scenario by expanding its middle class in such way that it includes those Chinese who were more or less bypassed by the swift growth of the past four decades. In his book *The Myth of Chinese Capitalism: The Worker, the Factory, and the Future of the World*, Dexter Robertson (2020) points out that the existing Chinese middle class, estimated by McKinsey consulting company to be some 300 million, cannot spend much more than its current consumption. This is why dynamizing the Chinese growth would require expanding the middle class, which, in turn, would require loosening the Party control. Such course of events would first of all mean abolishing of hukou, or household registration system, which prevents a hundred million migrant workers from rural areas to become citizens of Chinese metropolises. In that case, the state should take it upon itself to provide social services such as education of children and limited health care for the growing number of lawful citizens, which implies high-

er costs and acceptance by the existing residents to share these services with *nóngmín gōng*, or newcomers.<sup>6</sup> By not touching the anachronous system from the 1950s, the Party wants to continue externalizing the costs of public services to the poorer communities where migrants have their official residence. This way, the Party also retains the most powerful social control tool – the possibility to order as many as half of China’s population where they are going to live.

The first and most important reform that would pave the way for a decades-long high economic growth is to increase the overall level of human capital. Despite the impressive results of Shanghai students at PISA tests and more than four million STEM graduates every year, this level is surprisingly low. In every country that has managed to avoid the middle income trap, at least 50% of the work force has a high-school diploma. Japan, South Korea, Taiwan, Singapore and Hong Kong are the only formerly undeveloped countries outside the Western civilization that managed to avoid the middle income trap and the average share of high-school education in their work force was 76% (Chorzempa and Huang, 2021). At the moment, China has only 30% of work force with at least high-school education and is thus trailing behind almost every other middle income country when it comes to this criterion. With such a millstone round its neck and assuming that it will keep delaying the key reforms such as introduction of free high-school education and high-quality programs of lifelong education, China has no chance of joining the club of high-income countries as early as by 2025 or doubling its GDP by 2035.

The second reform important for the creation of a bigger and wealthier middle class is enabling the rural inhabitants to use their own land and their land use rights for improving economic situation. China has a long way to go to strengthen ownership rights and independent judiciary – which still often remains a dead letter today. Chinese law does not recognize private ownership of land, only state and communal ownership. Unlike urban population who can sell their properties, rural population cannot sell their land for non-agricultural purposes. In rural areas, local self-government is the only one that can sell or lease communal land for commercial purposes. Due to the specific approach to fiscal decentralization, local self-government units have excessive burden on the expenditure side of their budgets because the central state has delegated too

<sup>6</sup> The real “harmony” among the Chinese population is clearly visible in the pejorative term *waidiren* used for the migrants from rural areas and in the fact that they often end up as scapegoats for most of the urban problems.

much authority to them without relinquishing adequate tax revenues. In such a situation, local self-government units are very dependent on selling the communal land to developers as a dominant source of income. This way they blow the real-estate market bubble and deny land users their direct source of income.

#### PARADOXICAL COEXISTENCE OF BOTH THE NEED TO STRENGTHEN AND THE NEED TO WEAKEN THE ROLE OF THE STATE IN CHINA

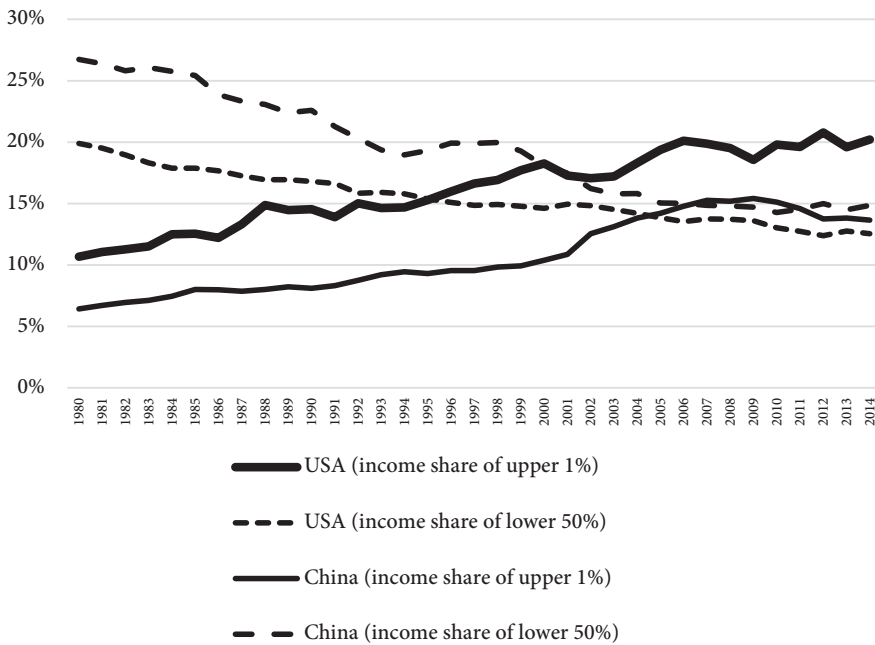
According to Professor Michael Pettis from the University of Tsinghua, the imbalanced structure of the Chinese demand can only be maintained by increasing debt or social transfers and transfers of state property to households, if escalation of the unemployment problem is to be avoided (Pettis, 2013). The dubious lack of social transfers arises from the very regressive tax structure, particularly for the poorest Chinese. IMF has calculated that the lower 50% of China's population pay income tax at a rate higher than any other category of the population, save for the top 5% highest earners (Robertson, 2018). Also, the fixed nominal amount of social contributions places a particular strain on poorer households, since the effective tax rate exceeds 40%. Unlike the 25% average in the OECD member states, the tax income in China makes up only 6% of the budgetary revenue (Zhang et al., 2018). As there is no property tax that would prevent excessive construction, the tax system primarily relies on value added tax and social contributions that exhaust the purchasing power of most of the citizens.

The income inequality resulting from corruption, regressive tax system and rudimentary social transfers makes households save too much and thus limits the growth of domestic demand. The upper 10% of the population in income distribution save 50% of their income, while the lower 10% save 20% of their income, which is much more than the OECD average (Zhang et al., 2018). This confirms the thesis that there are significant transfers in the OECD economies that maintain higher consumption even among poorer cohorts of the population.

By all indications, the fiscal policy in China has had a very limited role in reducing income inequality. This is primarily due to the absence of reforms and their redistributive effects that would push China to a more sustainable growth trajectory. China's high-level income inequality limits its potential growth and

the extreme inequality in distribution of wealth carries in it the seed of financial instability (Figures 15 and 16).<sup>7</sup> Despite certain improvements, such as the deceleration of income and wealth inequalities indicated in World Inequality Database for the period from 2008 to 2015, the latest data covering inequality on the basis of Gini coefficient trends indicate another reversal.<sup>8</sup>

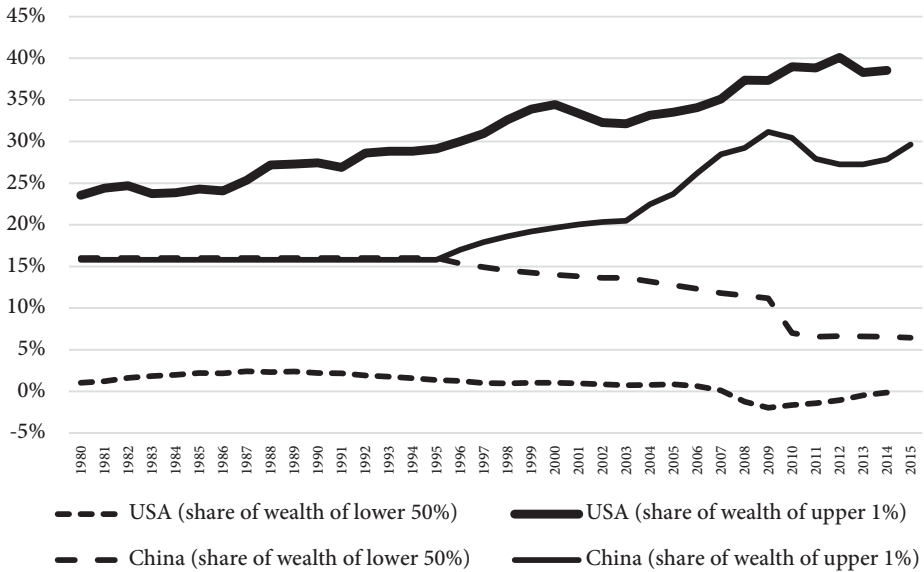
*Figure 15 Share of the upper 1% and lower 50% in U.S. and China*



Source: WID, 2018

<sup>7</sup> The data obtained by this author from Professor Li Shi from Beijing Normal University in personal correspondence several years ago reveals an extreme growth of wealth inequality. In the period from 2002 and 2010, Gini coefficient for this sort of inequality grew from 0.537 to 0.758. When disaggregating the data by sectors, we can see that 97% of the growth of wealth inequality can be attributed to the real estate sector and finance sector. The positive correlation between the growth of property inequality and growth of financial leverage resulting from the growing value of financial assets as a collateral for new credits certainly poses a serious risk for China's financial stability.

<sup>8</sup> According to Statista, Gini coefficient (0 – complete equality, 1 – complete inequality) in China grew from 0.462 in 2015 to 0.468 in 2018. This fits in the earlier described mechanisms of internal imbalances that have been growing in the past years.

*Figure 16 Share of net wealth of the upper 1% and lower 50% in U.S. and China*

Source: WID, 2018

Together with the reform of state-owned enterprises, the reform of the Chinese tax system and public consumption system would be a great catalyst of Chinese and global growth. It would be a classic win-win scenario for both China and the rest of the world. But such a reform implies simultaneous strengthening and weakening of state in its various functions. The strengthening of China's fiscal capacity and public consumption would strengthen the distributive and stabilization functions of fiscal policy, particularly in the long run. On the other hand, liberalization and privatization in the sectors dominated by state-owned enterprises would reduce the long-term allocation function of the state, particularly in the domains where this role is counter-productive. Still, this situation very accurately shows how, even in the case of a supposedly foresighted and very disciplined system, the first law of economics which postulates scarcity of resources is often ignored because the leading role is reserved for the first law of politics which deliberately ignores the first law of economics. And finally, China's transformation is impeded and prevented by the leadership who wants to maximize the political control in the system and

by the supporters of the status quo who, siding with the current leadership, want to retain the existing economic and political rents.

If we add to the abovementioned anomalies of state capitalism 2.0 the questionable form of China's territorial organization and the strength and numbers of "red capitalists" who, according to Credit Suisse, are found particularly among the 4.4 million Chinese dollar millionaires (Khan, 2019) and who practically did not exist at the beginning of this millennium, then we can obtain a better view into the world of political limitations to the reforms. Particularly confusing for the less informed external observers is the inability to introduce a more progressive tax system and social transfers, even when the system is ruled by a communist party with a very powerful individual at the helm, seemingly donning the mantle of Marxism. Although it is easier for Xi Jinping to control Chinese red capitalists than it is for Vladimir Putin to control Russian oligarchs, he is certainly in no position to ignore more than 90 million Party members who often have heterogeneous interests, assuming we put aside the ultimate goal – survival of the one-party system.

All this shows that the middle income trap is primarily a political, not economical problem. Bearing in mind the still potentially huge pool of talented work force, China should not experience any major economic slowdown for another decade, maybe two. Still, in the past episodes of the countries that fell into the middle income trap, like Mexico, Argentina or Brazil, local elites believed that the progress they had achieved was enough as such and were not willing to give up control over wealth and political system in return for depersonalized political and economic institutions. Actually, the dilemma of the Party elite members can be described like this: Do they want to live as moderately powerful individuals in an exceptionally prosperous society or maintain absolute control in a moderately prosperous society? (Babones, 2012). Surrendering the leading role to market allocation of resources has always been a dialectical challenge for the Party, which cannot retain full control over the system either with or without an expanded and strengthened market supported by the growing and increasingly prosperous middle class. This fundamental contradiction hides the limitations of exporting the authoritarian political system and own political capitalism to the rest of the world.

A detailed overview of the winners and losers of the pro-market reforms can be seen in Table 2. Liberalization of interest rates, increasing competition in the financial sector, liberalization of exchange rate policy that will certainly

lead to appreciation pressures on the yuan, privatization of state-owned enterprises and communal land and introduction of social safety net – these are all the steps that imply enormous redistributions and disrupt the existing political balance.

*Table 2 Winners and losers of pro-market reforms in China*

|  | <b>Winners</b>   | <b>Losers</b>   |
|--|--|---|
| <b>Renminbi appreciation</b>   | Households as consumers, particularly middle and lower middle class<br><br>Service sector<br><br>Importers   | Exporters and their political sponsors<br><br>Central bank (reduction of dollar value of assets compared to liabilities in yuans)                                     |
| <b>Liberalization of interest rates and strengthening of competition in financial sector</b> | Households as savers, particularly middle and upper middle class<br><br>Service sector<br><br>Labor-intensive industries<br><br>Small and medium enterprises | Capital-intensive industries<br><br>Local self-government units<br><br>Speculators with access to favorable “margin” credits<br><br>Developers and real estate sector |
| <b>Privatization of state-owned enterprises and communal land</b>                            | Households; final effects depending on type of privatization   | Government sector, particularly Party members on all levels of power  |
| <b>More progressive taxation system and strengthening of social transfers</b>                | Chinese migrants<br><br>Lower middle class<br><br>Service sector<br><br>Consumers and trading sector<br><br>Consumer goods industry                          | Red capitalists<br><br>Upper middle class (at least short-term and medium-term)   |

Source: the author



## PAX SINICA BEHIND THE CORNER?

China is still not ready to become a true locomotive of growth in the post-corona crisis era, or a global leader that could gather around it a strong coalition of countries dedicated to generating global public goods. In 2020, China partially managed to achieve only one of the three stabilizing functions that, according to Kindleberger's hegemonic stability theory, a hegemon or a power aspiring to such a role should play (Kindleberger, 1973). China has been only partially successful in maintaining an open market for importing goods the demand for which has been reduced due to the corona crisis (distressed goods). The final quarter of 2020 saw a recovery of the Chinese import of goods and services, but its dynamics was not enough to increase substantially the share of Chinese import of goods and services in the overall global import, as can be seen in the UNCTAD document *Key Statistics and Trends in International Trade 2020*.<sup>9</sup> Besides, in the same year, China failed in achieving two other stabilizing functions: long-term countercyclical international investing and the "lender of last resort" function". These developments were a continuation of a trend that had begun before the pandemic, as a result of geopolitical tensions in the world and the questionable implementation of various projects under the Belt and Road Initiative (BRI) (Kynge and Wheatley, 2020; UNCTAD, 2020; OECD, 2021). A number of BRI projects have been riddled with problems like greatly exaggerated costs, corruption, total disregard of environmental impact studies and workers' rights during project realization, lack of transparency and growing debt of the countries deeply involved in the initiative. It is a result of often poor coordination and planning of the projects due to excessive ambitiousness, naivety and arrogance of the Chinese leadership. Such a conclusion may sound counterintuitive to a superficial external observer, given the dominant perception that the Chinese system is monolithic and that its strategic plans are carefully worked out to the last detail.

Also, relying on China as a global leader in providing global public goods is almost impossible to imagine in the conditions of a growing distrust between China and the West. China's moves in 2020 only deepened the credibility gap that had already appeared due to China's tendency to use economic

<sup>9</sup> Statista data shows that, in the period from 2016 to 2019, China's share in the global import of commercial services dropped by 0.88 percentage points, while the country's share in import of goods grew by 1.02 percentage points (Ma, 2020).

arm-twisting against the countries who dare question Beijing's actions. These moves included continuing the confrontation course in South China Sea, de facto derogating Hong Kong's autonomy by passing the National Security Act (thus violating the China – UK declaration of 1984), de facto suspending clauses from the Sino-Australian Free Trade Agreement after Australia had dared insisting on an independent WHO-led investigation of the origins of SARS-CoV-2, and continuing the repression against the Uyghurs. In such conditions, it is hard to expect from China to be a completely reliable partner even in the issues where there is global consensus, if not more than just lip-service, such as achieving carbon-neutral economy by 2050, or not later than 2060. Despite its proclaimed dedication to investments in renewable sources of energy, China does not hesitate to increase its investments in the most damaging sources of energy such as coal. As a result, the share of such projects both within the BRI initiative and domestically is also growing (Shepherd, 2021). This is why the climate change problem will be easier to deal if liberal democracies substantially increase their own investments instead of naively yielding in the issues like human rights or problems related to the Chinese model of state capitalism, only to win China over for the global climate agenda (Rohac, 2020).

Keeping in mind the four scenarios for China's future offered by the acclaimed RAND Corporation in the document *China's Grand Strategy*, chances that an implosion will take place in China that will lead to significant destabilization of its political and economic system are very small (Schobell et al., 2020). Equally unlikely is the second scenario – the one in which China triumphs, its Party achieves all of its goals and the world enters a new era that could be called *Pax Sinica*. The remaining two scenarios are much more likely.

The third scenario sees China growing and Beijing achieving many but not all of the goals of its “national rejuvenation” strategy, which implies achieving a well-governed, socially stable, economically and technologically prosperous and militarily powerful state by 2049, for the centennial of the founding of People's Republic of China. And the fourth scenario refers to a stagnating China in which the Party, despite all the adversities, manages to retain the political monopoly.

Despite some new, contrary winds, the “stock” of Western liberal democracies is much better off than is usually believed given the burden of the corona crisis. This will be discussed in detail in the next chapter. China's influence on the world developments will be definitely growing, but the wide

coalition of liberal democracies is in a good position to ensure its own prosperity and preserve the values on which it is based, without actively aspiring to have its economic and political models universally applied (Rodrik, 2021). This is why the British initiative about closer cooperation within the new D-10 format – instead of the somewhat obsolete G-7 format – should be welcomed and also expanded a little by including other liberal democracies, particularly the new ones in undeveloped countries. Similarly, the Biden administration's initiative to host a Democracy Summit is also welcome as an attempt at making democracies more resilient in the new era of rising authoritarianism. The global match between Western and Chinese standards cannot be won if the key fast-growing markets with the highest potential for the growth of digital economy are neglected.<sup>10</sup> The liberal democracies will also have to work thoroughly on revitalization of their respective societies and economies in order to be resistant to the pressures of China's leaders. More on this will be said in the next chapter.

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<sup>10</sup> In addition to the U.S., Japan, Germany, Great Britain, France Canada and Italy, D-10 also includes South Korea, Australia and India.

## CHINESE AUTHORITARIAN VIRUS AND THE FATE OF LIBERAL DEMOCRACY

*The Chinese system offers a new option for other countries and nations who want to speed up their development while preserving their independence.*

Xi Jinping, 2017

### GLOBAL STRENGTHENING OF THE AUTHORITARIAN VIRUS AND POLITICAL CAPITALISM

The past few years have witnessed disturbing strengthening of global influence of authoritarian regimes such as the ones in China and Russia. As if it were not challenge enough, this scenario builds on the concept of “democratic recession” which, according to the acclaimed American political science professor Larry Diamond (2015), is manifested in a decreasing efficiency and increasing polarization within Western liberal democracies. A moderate but continued erosion of the liberal-democratic institutions worldwide has been particularly visible after 2008, as a reaction to the aftermath of the global financial crisis (Funke et al., 2016).<sup>11</sup> In the context of such an impaired “immune system” of established liberal democracies and due to the resulting destabilization of the new, unconsolidated democracies, there is a growing threat of the seemingly unstoppable onslaught of authoritarian regimes (Figure 17). Although Russia has regularly been in the focus of all those concerned about the fate of Western

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<sup>11</sup> Ample research shows that financial crises are followed by growing fragmentation of the political scene, growing support for extreme political options and extrainstitutional pressures on the political arena in the form of industrial strikes, antigovernment demonstrations and street violence. One of the most comprehensive studies is the one entitled *Going to extremes: Politics after financial crises, 1870-2014* by three German economists, Manuel Funke, Moritz Schularick and Christoph Trebesch. We should mention here that the last global financial crisis indirectly undermined new democracies because the magnetic attraction of the liberal-meritocratic capitalism led by the United States had become weaker due to the initially sloppy crisis management that did not take enough account of the just and efficient allocation of financial losses.

liberal democracies,<sup>12</sup> China has recently attracted increasing attention – and for a reason.

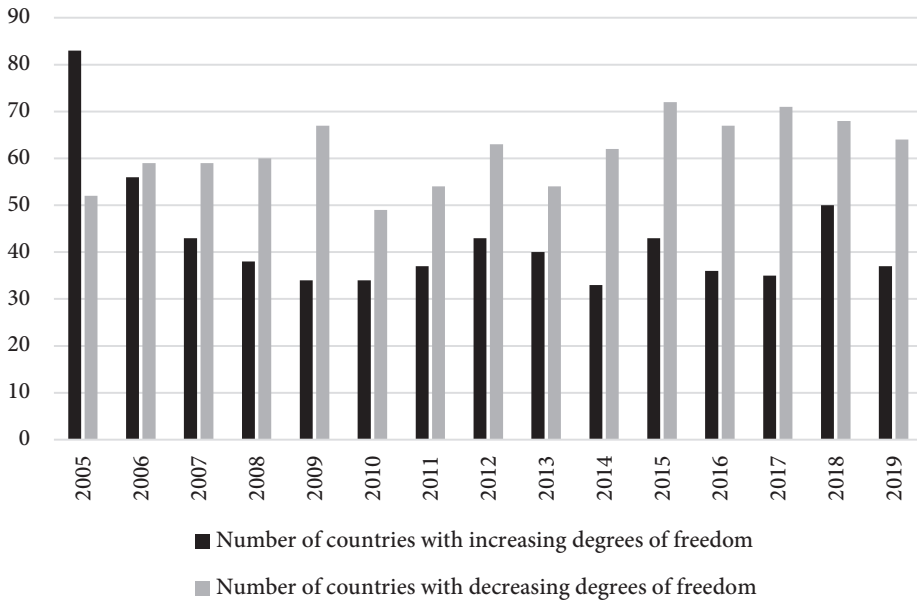
In the discussions about the rise of China, the predominant dilemma was whether this rise had been peaceful and aiming at China becoming a responsible global stakeholder in the existing multilateral institutional architecture or whether it had had revisionist motivations and aiming to impose a Sinocentric economic and political order at the expense of the existing domination of the Western-centric multilateral institutions. Until recently, a narrative about an “economic China” which is primarily dedicated to its own economic development and modernization has dominated the Western business, academic and political circles. To achieve these goals, China was supposed to ensure its active participation in the economic globalization process, so the Western political and business elites mostly believed that the political and economic liberalization in China would continue, supported exactly by Chinese participation in this process. Such a belief of some of the observers was additionally strengthened by Xi’s speech at the World Economic Forum in Davos in 2017, which resonated globally. In it, Xi said that the problems encumbering the world were not caused by globalization, hinting at the increasing protectionism of Donald Trump’s administration. At the APEC summit the same year, he said: “Openness brings progress, while self-seclusion leaves one behind” (Xinhua, 2017).

This rhetoric had to be compared with concrete moves and actions of the official Beijing in order not to miss the wood for the trees. From this perspective, we could conclude that Xi’s China was a promoter of asymmetric and selective globalization. Under Xi’s leadership, “political China” has manifested a growing tendency to accumulate more power and substantially strengthen its international influence, which is clearly directed towards intensifying the global path of authoritarianism, given the simultaneous strengthening of the repressive nature of the Chinese regime domestically. In the period of fight against the coronavirus and its economic consequences, China’s domestic repressive actions and spreading of the authoritarian virus abroad will be additionally emphasized. Chinese regime will be strongly motivated to cover up its own irresponsibility and the very questionable crisis management that enabled the global spread of the virus, as evidenced by renewed calls for investigation

<sup>12</sup> At the last year’s G20 summit in Osaka, Vladimir Putin bluntly said that “(...) liberalism has become obsolete and outlived its purpose” and that “it has come into conflict with the interests of the overwhelming majority of the population” (BBC, 2019).

on the origins of SARS-CoV-2 by several experts of the WHO's special mission to China. The regime will also try to gain important political points which it believes would be more difficult to gain if it wasn't for this state of emergency.

*Figure 17 State of freedom in the world according to Freedom House*



Source: Freedom House, 2020

This is why this chapter will analyze three tools that Chinese regime has been combining in order to strengthen its global influence and undermine liberal democracies and their basic values: soft, hard and sharp power. In addition to this, Xi Jinping's key foreign policy initiative Belt and Road and the efforts to internationalize Chinese currency, the yuan, will be briefly mentioned. All these tools and initiatives were operational even before the corona crisis, with various degrees of success, so our task here is to try to throw some light on the pandemic's effects on their long-term efficiency and on the liberal democracies' position in relation to China. But before we elaborate on the Chinese soft, hard and sharp power, let us once again remember how China became a champion of the asymmetric or selective globalization.

## CHINA AS A CHAMPION OF THE SELECTIVE AND ASYMMETRIC GLOBALIZATION

There is no doubt that almost all of Xi Jinping's moves, particularly after the 2015 crash of the Shanghai stock exchange, fit in the trend of building regulatory walls supposed to establish selective control of the flows of ideas, culture and capital between China and the rest of the world (Economy, 2018). For example, while as of recently it has been almost impossible for non-Chinese civil society organizations to maintain its presence in China, the number of Confucius Institutes in the rest of world has kept growing. Access to American social networks is still forbidden in China and the U.S. technological companies with access to Chinese market, such as Apple, must meet the increasingly harsh restrictions in order to maintain their current position. In order to be allowed to stay in Chinese market, Apple had to remove a hundred or so apps from its online shop that Chinese citizens had been using to circumvent the "Great Firewall of China" – the world's most sophisticated type of control of access to the Internet contents. The company also had to agree to localize its data on Chinese servers in order to make it easier for the online censors to process them (Cadell, 2017). On the other hand, the same cannot be said for Chinese technological companies like Huawei, which are rapidly spreading around the world backed with government subsidies. According to some calculations, the overall direct and indirect support in the amount of as many as USD 75 billion includes free land plots, subsidized credits, grants and tax reliefs; the company also benefits from the Belt and Road Initiative, lavishly sponsored by Beijing as its key foreign policy initiative (Darby and Sewall, 2021).

Evidence that this asymmetry is not only an economic problem can be seen in the fact that Huawei and similar companies are legally and constitutionally obliged to cooperate with Chinese authorities (Lian, 2019). This cooperation includes not only defensive actions aiming at maintaining stability domestically; they are obliged to cooperate with intelligence agencies, which also includes operations outside China. Also, when we talk about technological companies as means of potential espionage, we should point out the difference between the American and Chinese approach. Unlike the U.S., China nurtures industrial espionage, aiming to get hold of the patents and commercial secrets of foreign companies and sharing these with Chinese companies in order to

enable their rapid development (Giglio, 2019). Yasheng Huang, an MIT political economist, claims that Huawei is strongly supported by the Chinese army and that it would be totally unthinkable that a “politically naïve entrepreneur” such as Ren Zhengfei, Huawei’s founder, could achieve such success without approval and support of the Party structures (Huang, 2008).<sup>13</sup>

Although China has selectively liberalized foreign investment in the past few years, primarily because it wants to neutralize the disturbing outflow of capital and the resulting shrinking of foreign exchange reserves that have taken place after 2015, the OECD’s FDI regulatory restrictiveness index for China is still high (0.251), as compared to the average for the OECD economies (0.065) (0 = totally open for investments; 1 = totally restricted for investments). In this respect, China still has one of the most restrictive frameworks for direct foreign investments in the world. Also, in terms of Chinn-Ito index which measures the total freedom of capital inflows and capital outflows, very tight control over capital account of balance of payments is still in place in China. According to economist Barry Eichengreen, this control has even been additionally tightened (Eichengreen, 2017).

As for the existing multilateral standards, China made the biggest progress in trading sector, after it had joined WTO in 2001. However, despite of decades of economic liberalization, China still has the average weighted tariff rate on imported goods twice as high as the U.S. and European Union (3.39% compared to 1.59% and 1.69%, respectively – according to World Bank). For this reason, it has not yet been granted the status of a market economy in WTO. This is primarily because China strongly relies on the economic instruments typical of political capitalism. No wonder that the United States and European Union still want to have some maneuvering space for implementation of economic countermeasures, such as anti-dumping duties, intended to neutralize China’s acquired advantage.

<sup>13</sup> Huawei’s CEO is also a member of the Chinese Communist Party and its executive director is the secretary of the Party cell in the company. Huawei claims it is 99% owned by its employees, but formally it is the company’s Union Council that is registered as the owner of its shares. If the said council functions as such councils in other Chinese companies – and it is very unlikely that this is not the case – then we say that Huawei is de facto controlled by the state. In this case, workers participate in the profit distribution system only and have no ownership or governing rights in the company. Also, Huawei rose in the period when other Chinese private companies were not allowed to do business in telecommunications sector – yet another indicator of a close relationship between the company and the state. Whoever it is that really owns and runs the company, it is certainly not its employees, as is officially claimed (Balding and Clarke, 2019).



If the above facts are placed into a broad context, it becomes perfectly clear why China has increasingly been perceived as a serious economic and security threat in the past few years. After it was famously labeled in the U.S. National Security Strategy and Defense Strategy as the key security threat, China also met with growing criticism from the European side of the Atlantic. In the 2019 European Commission document entitled *EU-China – A Strategic Outlook*, China is labeled not only as a partner in dealing with common challenges such as global warming, but – for the first time – as an “economic competitor which is trying to take over the technological lead and a systemic rival which promotes alternative models of governance” (European Commission, 2019). In the post-coronavirus pandemic period, China will try to accelerate these trends and use the leadership vacuum that currently exists in the world. The tools that China has been using to achieve its goals will be analyzed in the following sections.

#### THE LIMITATIONS OF CHINESE SOFT POWER AS A POTENTIAL THREAT TO LIBERAL DEMOCRACIES

In the past decade, China has intensively attempted to use soft power as a tool for promotion of its interests in the rest of the world. According to Harvard professor Joseph Nye, soft power does not arise from the propaganda apparatus of a particular country; instead, it stems directly from the cultural appeal of its society, political values that its institutions and prominent individuals promote domestically and abroad, and, finally, the foreign policy which is considered to be legitimate and to possess moral authority (Nye, 2004).

According to estimates, China is spending more than USD 10 billion per year in order to win favor of the rest of the world. The United States, for example, spends as many as ten times less. Nevertheless, the Chinese approach simply does not yield the desired results.<sup>14</sup> For example, in 2019, the composite index Soft Power 30, published by *Portland* and *USC Center for Public Diplomacy* and used for measuring soft power in 30 countries in the world, ranked China as low as on the 27<sup>th</sup> place (The Soft Power 30, 2019). By comparison, the

<sup>14</sup> China is the most popular in Africa, where the respondents who positively perceive the idea of Chinese world leadership exceed in numbers those who do not share such attitude. In both Americas, Australia, Europe and Asia it is the other way round (Reinhart and Ritter, 2019).

United States was ranked fifth.<sup>15</sup> China not only failed to cultivate a large number of supporters of its model in the rest of the world – it lost the confidence of those who, until recently, had nurtured confidence in Chinese intentions and in China as a benevolent power. So, the change of heart can be seen not only in the gradual change of the metalanguage of official institutions and governments of liberal democracies, but also among the general public. We should note here that the percentage of Western European citizens with positive perception of China recorded a two-digit drop in the period between 2018 and 2019 (Silver *et al.*, 2019).

Figures 18 and 19 show the recently available data of *Pew Global Research* for 2019. If we move away from the small circle of Western liberal democracies and try to see things in a broader perspective by including in the sample the most populous and fast-growing economies, particularly those which are also democracies, it is clear that, for now, China is not winning the “hearts and souls” of their populations. The latest *Pew Global Research* report shows that the unfavorable perception of China in early autumn 2020 reached its historical peak in 14 developed countries and that the median of the respondents who think that China’s handling of the pandemic was poor reached 61% (compared to 37% of those with the opposite opinion) (Silver *et al.*, 2020).<sup>16</sup> As opposed to this, a median of 81% of the respondents think that the U.S. also handled the pandemic poorly. However, the relative gloss of China’s success in containing the pandemic will gradually fade away even compared to the bad initial situation found by the administration of America’s new president Joe Biden – for two reasons: First, as the Biden administration placed the fight against the pandemic on top of its own list of priorities, in early April the U.S. had the fifth highest vaccination coverage rate in the world, after Israel, United Arab Emirates, Great Britain and Chile (Peel *et al.*, 2021). Second, the latest research shows that at least one third of the difference between SARS-CoV-2 death rates in the U.S. and China resulted from Beijing’s cover-up of the official

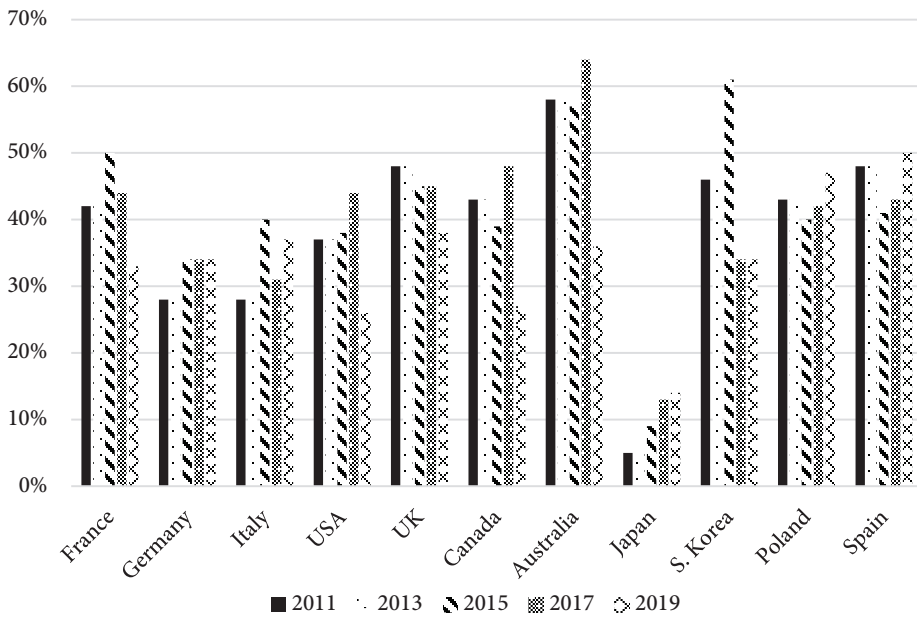
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<sup>15</sup> In the period from 2016 and 2019, the U.S. dropped from the 1<sup>st</sup> to the 5<sup>th</sup> place. The index combines objective and subjective indicators of the popularity and leadership of particular countries in categories such as: digitalization, entrepreneurship, education, culture, public diplomacy and the appeal of political institutions.

<sup>16</sup> The only domain where China is perceived as strong is its economic power: a median of 48% of the respondents believe that China is the leading global economic power, compared to 35% of those who still believe that it is the U.S.

death rates, while the remaining two thirds pertained to the incompetence of the Trump administration (Cukierman, 2020).

*Figure 18 Percentage of the population with positive perception of China, selected countries 1*

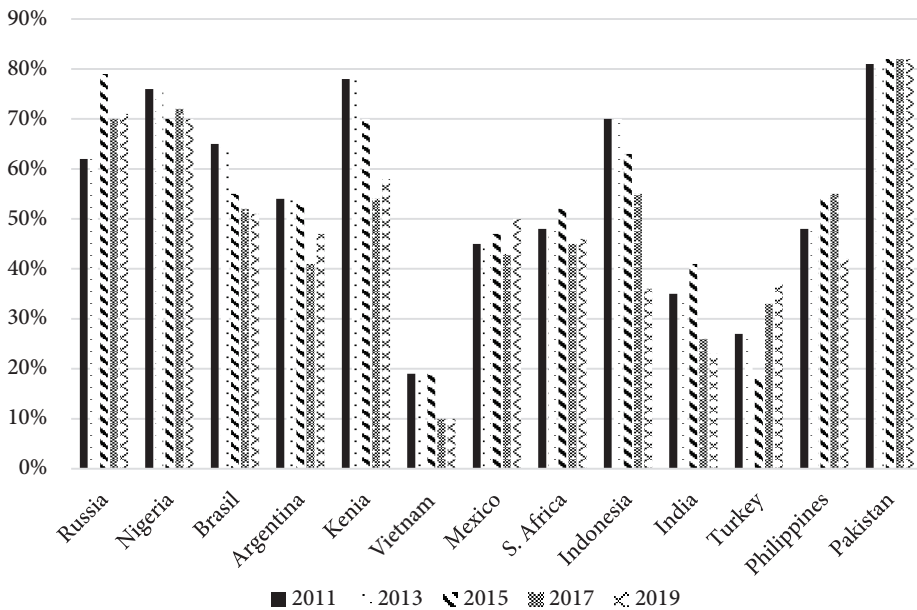


Source: Silver et al., 2019

China's rating in this category will get even worse in the post-corona crisis era. The world was already informed that China had not reacted on time and prevented the spreading of the virus although it could have, that it had refused to share the precious and timely information, e.g. that the virus can be transmitted from human to human, and that it had restricted – and is still restricting – transparent and free investigations about the origin of the virus (Jutarnji.hr, 2020). These moves cannot simply be erased by a simple “mask diplomacy”, which is increasingly believed to be but a bad PR. As time goes by, it is becoming clear that donations account for only a very small percentage of the delivered anti-pandemic material and equipment; it is even more shocking that a large percentage of this equipment is faulty (Braw, 2020). In the first weeks of the pandemic, China may have won for itself a few minor points with the help

of the “mask diplomacy”, but later developments showed that the EU was more than ready to deal with the crisis in a functional and solidary way. We should mention here that Germany and France between them donated to Italy more face masks than China, although this fact did not get such media coverage as the case of the initial donation of Chinese masks (Dunst, 2020). Chinese “mask diplomacy” temporarily bought the friendship of some countries (e.g. Serbia, Venezuela, Angola and Ethiopia), but these are the countries with marginal influence on the world order. Also, in contrast to the said short-term gains there is the increasingly aggressive Chinese “wolf warrior diplomacy”, part of which is the practice of Chinese embassies around the world to use Western social networks – which are banned in China itself – for attacks on those whose views or theses are considered by the Party to be objectionable or dangerous for its political primacy. After the outbreak of the coronavirus pandemic, particularly objectionable are the viewpoints that do not fit in the official Party narrative about the origin and spreading of the virus.

*Figure 19 Percentage of the population with positive perception of China, selected countries 2*



Source: Silver et al., 2019

Such diplomacy, oriented primarily to winning trust and maintaining loyalty of domestic audiences and not to integration and constructive cooperation with non-government and government actors outside China, is contrary in its essence to the concept of diplomacy. Symbolic delivery of assistance cannot substitute transparent communication on the virus origin. Furthermore, Chinese politicization of medical assistance, continuing misinformation-spreading campaigns, lack of constructive participation in multilateral institutions and of building trade and investment relations that do not function as a one-way street, all remain major obstacles to constructive diplomatic engagement. When all this is taken into account, there are no valid reasons for perceiving the Chinese authoritarian leadership as more attractive in the post-pandemic era just because the popularity of the American leadership has dropped. Approving someone's leadership or soft power is not the zero-sum game in which one side definitely wins what the other side loses.

#### “VACCINE DIPLOMACY” AS A NEW SPACE RACE

As a new frontline of the narrative of superiority of the Chinese approach, the “mask diplomacy” turned out to be a double-edged sword for China's global aspirations in the first half of 2020. The initial announcements about new friendships sealed up with the delivery of face masks failed the test of time. This is the visible risk arising from the difference between the great expectations supported by the grandiose statements of Chinese officials and the actual moves in the field. Glimpses of similar developments can be seen behind the Chinese “vaccine diplomacy”. Despite big promises, Chinese “vaccine diplomacy” suffers from a few key problems: repeated delays in vaccine delivery, inconsistent clinical study results, delays in the vaccine approval procedure in the third phase of clinical testing<sup>17</sup>, the obsolete preparation technology that has negative effects on the efficiency of Chinese vaccines compared to Pfizer-BioNTech, Moderna and even AstraZeneca vaccines (Wee, 2021; Wee and Qin, 2020). Besides the risk of tarnished reputation in cases of failed or delayed deliveries of vaccine (NEWS18, 2021), an additional risk that could appear after

<sup>17</sup> By the first half of April 2021, not one of Chinese vaccines had obtained approval of food and vaccine regulatory agencies such as American FDA, European EMA or equivalent agencies in the developed liberal democracies such as Japan, Canada, Australia etc.

China launches mass production of vaccines will be the unscrupulous individuals or companies in the countries with low level of governance and high level of corruption (Mardell, 2020). Similar scandals, like mass sale of forged or expired vaccines against polio, tetanus, diphtheria and rabies, have been causing concern and abhorrence of Chinese citizens for years (Wee and Chen, 2019). Unfortunately, citizens' concerns and panic are often hushed up without fundamental improvement of regulatory standards.

And what is the situation with the key liberal democracies in this respect? Not only that Pfizer-BioNTech, Moderna and AstraZeneca vaccines were the first ones to pass three phases of clinical studies and obtained approvals from major world regulators, but liberal democracies are also way ahead with vaccination of their citizens. True, the vaccination campaign in the European Union has met with some problems. European Commission and some Member States have not done well in planning the purchase of the vaccine. They also occasionally showed disorientation. However, many of those who claimed last year that the West should apply the Wuhan model in fighting the pandemic and were eager to proclaim the triumph of Chinese experience over those of the rest of the world will be quite surprised when they take a look at the interactive tool *Our World in Data* that shows the vaccination coverage rate per 100 inhabitants (Our World in Data, 2021). On 8 April 2021, China was worse off than all the biggest EU economies such as Germany, France, Spain, Italy, Poland, Netherlands and even Romania. As for Great Britain and the United States, by then they had left all of these countries behind, showing to the world that the Anglo-Saxon economies, which – to say the least – had not done particularly well in the pandemic management in 2020, were definitely not for write-off. As regards the long-term implications of the Chinese “vaccine diplomacy”, it is important to point at two questions to which China cannot offer even remotely satisfactory answers at the moment of writing of this book.

First, how a country that was not among the first ones to develop the highest-quality vaccines and vaccinate a major percentage of its population can be a leader in global health care? Second, even under the assumption that it has vaccinated a large portion of its own population, how can China be a leader if its contribution to the most important multilateral initiative for developing and distributing anti-SARS-Co-V-2 vaccine in a just and efficient way is incomparable with its economic relevance? By the way, COVAX (COVID-19 Vaccines

Global Access)<sup>18</sup> was established so that the purchasing states could share the risks and rewards in the joint acquisition of the vaccine. The initiative also facilitates planning and investment cycle of pharmaceutical companies; it guarantees purchase of a fixed quantity of vaccine even before it has been approved. The initiative includes 198 countries, 92 of which are low- and middle-income countries. They will be given subsidized, or even completely free, access to the vaccine. So, what is China's position in this respect? Way back last year, its president Xi Jinping said that the COVID-19 vaccine should be a public good but he never specified if and how much would it be charged?

Meanwhile, the U.S. and its Asian allies have launched a major vaccine drive to counter China. Basically, the plan envisages that 1 billion of Johnson & Johnson's Covid-19 vaccines will be funded by the U.S. and Japan, produced by India and distributed by Australia to the countries in the Asia-Pacific region to counter China's rising influence (Sevastopulo *et al.*, 2021). In addition, the U.S. and Great Britain have ensured more funds for COVAX than any other country – as many as USD 4.7 billion out of USD 6 billion collected so far. China promised to fund this initiative with USD 2 billion but, as of early April, there had been no actions with regards to this announcement (BBC, 2021). The Chinese leadership also announced they would reserve USD 2 billion for African countries and release a credit potential of USD 1 billion for the Caribbean and Latin America. This does not quite explain how Xi Jinping intends to treat the vaccine as a public good, for which there is no exclusion principle for non-payers. By mid-February 2021, COVAX made contracts with manufacturers for the delivery of 2 billion doses of the vaccine in 2021 (Serum Institute of India will deliver AstraZeneca and Novavax vaccines – a total of 1.1 billion doses; Johnson&Johnson will deliver 500 million doses; Sanofi-GSK will deliver 200 million doses; AstraZeneca will deliver 170 million doses which are to be produced in South Korea; Pfizer-BioNTech will deliver 40 million doses) (Daily Sabah, 2021). In the first two quarters, AstraZeneca will deliver 337 million doses of the vaccine by means of COVAX. For the sake of comparison, in early February 2021, three Chinese pharmaceutical companies (Sinopharm, Sino-vac and CanSinoBio) offered COVAX only 10 million doses, still waiting to be approved by Western regulators (Khaliq, 2021). But again, when it comes to

<sup>18</sup> COVAX was established as a joint initiative of Global Alliance for Vaccines and Immunization (GAVI), the World Health Organization (WHO), and the Coalition for Epidemic Preparedness Innovations (CEPI).

concrete actions instead of lofty words, in early April COVAX delivered more than 38 million doses to 92 countries on six continents. These doses were supplied by three manufacturers: AstraZeneca, Pfizer-BioNTech and the Serum Institute of India (SII). At the same time, there were still no Chinese vaccines in sight (WHO News Release, 2021).

Also, at the moment of completion of this book, the international price of the Chinese vaccines is not known yet, but the Chinese government will be paying USD 30.57 per dose for Sinopharm and Sinovac vaccines (Global Times, 2020), which is still much more than for the best vaccines such as Pfizer-BioNTech and Moderna. Similarly, the same can be said about Sinovac Biotech vaccine, with a price tag of a whopping USD 60 (Terry, 2021). The quality-price ratio is even more convincing for AstraZeneca vaccine that will be sold for the price of USD 2-5 per dose; also, it is convenient for distribution in tropical conditions because it can be kept in ordinary refrigerators (Cao, 2020). Such a competitive price will make the vaccine widely available in the developing countries to which Chinese pharmaceutical industry has been counting, in spite of controversies around AstraZeneca's safety. Russian Sputnik V with an innovative technology and the price of USD 10 per dose is also a much more attractive option in this respect.

Naturally, in the following months, China's diplomacy will continue and intensify the "vaccine diplomacy" in order to expand the market for its companies and gain additional leverage in its bilateral relationships with other countries. But the prospects that these efforts will be particularly successful are not glittering. Chinese vaccines presented so far are based on obsolete technologies, their price is not competitive, they are lagging behind their main rivals and they have not gained trust of the international public, as indicated in the recent YouGov survey on a sample of 19,000 respondents in 17 countries (Smith, 2021). But the European Union and U.S., still the key players in the global public health care, must not drop their guard yet. French president Macron is right in saying that, in order to contain the expansion of Chinese and Russian influence in the field, the European Union should redirect to African countries at least 5% of the vaccine it has ordered.

In the first few months of 2020, it seemed as if a "G-o world" was emerging, with a growing vacuum of power resulting from the absence of clear global leadership (Bremmer, 2017). As an international organization which, in normal times, would issue health-care guidelines based on objective scientific



evidence, the WHO was increasingly becoming a hostage of geopolitical turmoil and narrow interests. For example, in 2019, China managed to slip into *ICD* (*International Classification of Diseases*), the most influential document for categorization and classification of medical conditions and diseases in the world, the traditional Chinese medicine as one of legitimate ways of diagnostics and treatment of patients, although there is no scientific consensus about the efficiency of these methods (Nature, 2019). This clearly shows that China's influence on the making of important decisions is much bigger than its financial contributions and the membership fee to the WHO. In the budget period for 2018 – 2019, the United States paid USD 893 million, ten times more than China (Mazumdaru, 2020).<sup>19</sup> However, the Trump administration's open undermining of the multilateral approach made the WHO heads pay attention to new sources of funds and encouraged them to identify to a large extent with the values of the Chinese model of the fight against coronavirus at the moment of outbreak. Unfortunately, in this context, there were cases of a disturbing rapid decline of professional standards, global loss of confidence in the work of WHO and lack of intergovernmental coordination. All this could affect health-care responses in future crises.

Even if Donald Trump did win his second term in office, the relations between great powers and the nature of the global constellation of power would still be much more nuanced than the zero sum game – the logic that, whatever the United States loses, China (being its biggest rival) inevitably wins. Nevertheless, this worst-case scenario of the uncontrolled collapse of the Western liberal democracies' dedication to multilateralism did not continue. Joe Biden's triumph resulted in the U.S. returning to WHO and Paris Climate Agreement and its joining to COVAX and securing substantial funding for it. In addition to revitalizing the transatlantic relationships and strengthening the public-private partnership in health care, liberal democracies are also intent upon winning the battle in the domain of global health-care standards.<sup>20</sup> Of course,

<sup>19</sup> This influence is also illustrated by the fact that four Chinese citizens head 4 out of 15 specialized UN agencies: Food and Agriculture Organization (FAO), International Civil Aviation Organization (ICAO), International Telecommunications Union (ITU) and United Nations Industrial Development Organization (UNIDO) (Feltman, 2020).

<sup>20</sup> The global problem of collective action can only be solved with a multilateral approach. To this end, the nationalist instincts should be suppressed because, in the context of vaccine distribution, they make the wealthier countries securing disproportionate percentages of the vaccine for themselves and ignoring the needs of poorer countries – an approach that cannot result in a

this does not mean fencing China off and suspending it from the multilateral ventures such as the global fight against the pandemics and climate change, but some red lines should be drawn nevertheless, in order to avoid introducing corrupt compromises as a new normal in the light of (the totally unfounded) perception of China as an all-powerful country on an unstoppable rise.

**LIBERAL DEMOCRACIES ARE MORE IMMUNE TO THE  
AUTHORITARIAN VIRUS THAN IT IS USUALLY BELIEVED,  
BUT THEY SHOULD BE CAREFUL NEVERTHELESS**

Although liberal democracies do have certain problems, as can be seen from a *Pew Global Research* report (a median of 51% of citizens across 27 democratic countries polled are dissatisfied with how democracy is working in their respective countries, as opposed to 45% of those satisfied with it), it does not mean that most of the dissatisfied ones are willing to sacrifice the advantages of a democratic system by invoking the spirit of authoritarianism (Desilver, 2019). Just like market economies that have repeatedly proven their adaptability to new challenges, the political systems of liberal democracy are capable of doing the same. Despite the said democratic recession, we are still far from a third turning point that would change the achievements of the third large wave of democratization that began in the 1970s and is still going on.

Allan et al. (2018) show how a hegemonic order is always based on a legitimizing ideology that should be consistent with the identity on the level of both elites and masses. Their research included the distribution of identities in nine great powers (U.S., China, Japan, Germany, France, Brazil, Russia, Great Britain and India). Their conclusion was that the said distribution of identities supported the hegemony of Western and democratic values. Of course, China's deliberate use of sharp power and the lack of response of liberal democracies could redefine identity in the long run. However, it would take decades for China to achieve this because it is not clear what elements of the Chinese identity could become global.

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triumph over the pandemic in this globally networked world (Bollyky and Bown, 2020; Widakuswara, 2021).

On top of that, most of the citizens of democratic countries are aware of the advantages of the democratic system, despite the occasional frustration with the fact that their political representatives are not always capable of building a water power plant or an improvised hospital in a reasonable time. Still, they are aware that democracies feature the mechanism of democratic responsibility that enables the complex decision-making procedure to be compensated in the long run with the possibility of replacing bad policies with good ones. This mechanism also prevents concentration of excessive power in the hands of an individual or a small group of individuals. Concentration of power leads to collective disasters that American political scientist Francis Fukuyama calls “bad emperor problem”. Throughout history, it was a huge problem for large centralized systems such as Chinese empire (Fukuyama, 2018). And finally, the citizens of liberal democracies keep in mind the intrinsic advantages of living in liberal democracy; they do not observe the legitimacy of the order only through the glasses of instrumental rationality.

Unlike them, the authoritarian regimes such as the one in China, must always be alert not to fall into the economic abyss which tends to open because of the long suppressed issue of political freedoms and longtime tolerance of repression. Some may say it is this very caution and alert that make them keep improving their economic policies, but it is a far-fetched claim for two reasons. First, the process of long-term economic and political development contains a limited amount of “economic fruit on low branches” which can be picked while retaining repressive political institutions at the same time. Major technological breakthroughs that lead to a change of the technological paradigm are much more likely in liberal democracies where there is more freedom of experimenting regardless of its effect on the distribution of political power in the system.<sup>21</sup> Second, no regime in the world, democratic or authoritarian, cannot postpone financial crisis forever. Financial instability is simply engraved in the DNA of capitalism, with all its good and all its bad, and democracies are more capable of dealing with it, particularly because inherent instability is much harder to suppress in the long run and the long-term accumulation of risk in the system is lower than in authoritarian regimes.

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<sup>21</sup> The U.S. is still the world leader in basic research about artificial intelligence, robotics, software and biotechnology. As for China, it is the world leader in applied research and commercialization of existing technologies, owing to its big and protected market. For example, 60% of Chinese “unicorns” operate in Internet trade and video-game industry.

In addition to the abovementioned advantages, one should emphasize that, contrary to the often repeated and dangerous narrative that the Chinese authoritarian approach to containment of the coronavirus is much more efficient, it is actually democracies that are more efficient in fighting epidemics. According to *International Disaster Database* of the Catholic University of Louvain (UCL), dating back to early 1960s, democracies, regardless of their income levels, have shown lower epidemic mortality rates than non-democracies. The database also shows that, in authoritarian states, past epidemics killed six people per one million, as compared to the average of four people per one million in democratic states. This difference has a high statistical significance even when the control variables such as type of epidemic and different historical intervals in epidemic outbreaks are used (Economist, 2020).

As we said before, liberal democracies may be slower in building infrastructure but have much bigger advantages because they can rely on free flow of information and an open dialogue between the government and citizens. Authoritarian governments often fall victims of their own propaganda because political institutions generate an atmosphere suitable for cover-up of the bad news that lower-ranking officials hesitate to share with their superiors on time. The lack of proactive decision-making intensifies disasters because such behavior generally triggers huge costs in autocracies. Autocracies not only limit the flow of information, they also persecute critics and find politically suitable scapegoats.

Unlike this scenario, if an epidemic or environmental disaster occurs, democracies enable fast and constructive feedback about how functional and adequate particular government policies turned out to be in dealing with the crisis. Well-informed and motivated citizens who trust their political and economic institutions are more efficient in dealing with crises than a poorly informed and skeptical population under repression (Bejaković, 2020). Contrary to the often quoted trilemma which claims that only two out of three options – retaining liberal democracy, preserving healthy economy and preserving healthy population – are possible, experience tells us that there is a much wider range of options. The pandemic crisis showed us that the countries like South Korea and Taiwan can successfully balance between all three options because choosing between them is never absolute – it is always fluid and negotiable. The trilemma is often simply an illusion. For example, developing an application for tracking the infected and isolating their contacts should not necessarily be

perceived as giving up the achievements of liberal democracy. Technically and politically, it is possible to develop and implement applications notifying potentially infected persons about the need to take tests without revealing their identities as carriers to the users and to the government. Besides, in liberal democracies, new technologies enable not only the government's control over citizens, but also the other way around.

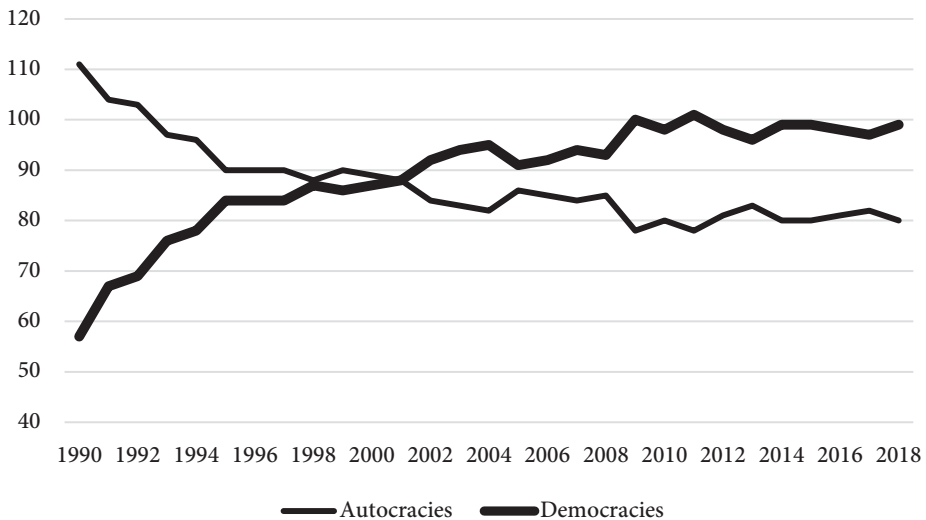
Nation states still constitute the key framework for organizing political life and this will stay one of the fundamental constants of international politics for a long time. Nevertheless, the challenges we'll be facing are becoming more and more global by their scope and consequences. For this reason, more extensive coordination of national policies will be required in the future, as the coronavirus case has shown. Along these lines, liberal democracies find it easier to negotiate and cooperate with each other because of the trust that represents their fundamental strength. It will be easier for liberal democracies to loosen the restrictions on traveling abroad if applications with cross-border operability are developed (and this will be possible only if adequate legislation has been passed beforehand as a guarantee of the protection of privacy). Contrary to a widespread opinion, such legislation is primarily a political issue, not a technical one, and liberal democracy can deal with it.

Contrary to the draconic restrictions of Chinese type and total loss of privacy, liberal democracies are the ultimate environment for encouraging voluntary mass use of interoperable applications by insisting on confidence and cooperation. The same degree of coordination will be needed for vaccine certificates, whose rollout should not hamper the freedom of mobility and should represent only one of the panoply of instruments for containing the spread of disease. They have more than adequate capacity to fight successfully against the medical, economic and political virus of authoritarianism. What they should do in order to preserve and mobilize this capacity is to stick to the fundamental values of liberal democracy such as freedom of expression, freedom of election, freedom from persecution, division of power, free media and independent judiciary. In the case of corona crisis, we have seen banning of movement and gathering. And yet, the consolidated liberal democracies have managed to avoid the trap of usurping political institutions by using state of emergency as an excuse. The restrictions were introduced for a limited period only and were mostly proportional to the challenge they were facing. Compared to China, where cameras for video surveillance are being installed even

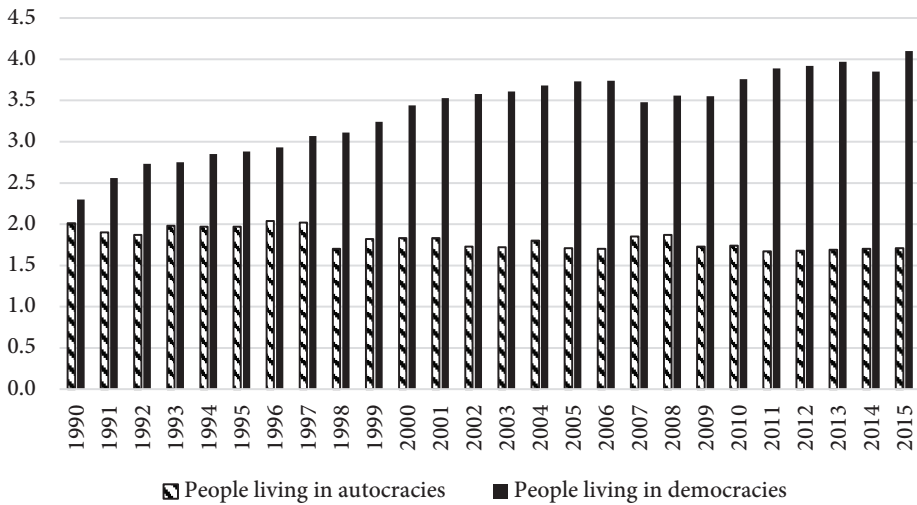
in citizens' homes (!), the citizens of liberal democracies like Germany or Netherlands have manifested confidence in peoples' common sense. Fines and – occasionally – short imprisonment are envisaged for the irresponsible ones.

The way things are now, Vladimir Putin and Xi Jinping will not be the grave-diggers of Western democracies. The number of democracies in the world is bigger than ever before. The same can be said for both the absolute and the relative shares of the world's population living in democratic countries (one should be careful here, though, and note that not all democracies are liberal and are thus not so immune to the authoritarian virus, as is the case in several post-communist countries) (Figure 20 and Figure 21). Despite their virtues and the fact that, on the freedom-and-prosperity side, their citizens gain from them more than they cede to them, liberal democracies should nevertheless be careful when facing such a strong exporter of the authoritarian virus such as the nominally communist China. In the next section we will name the main tools used by China in order to promote authoritarianism outside its borders.

*Figure 20 Autocracies and democracies in the world*



Source: Our World in Data, 2020b

*Figure 21 Number of people in the world living in autocracies and democracies*

Source: Our World in Data, 2020c

#### HARD POWER AND SHARP POWER AS A MEANS FOR PROMOTING CHINESE INTERESTS AND UNDERMINING LIBERAL DEMOCRACIES

Having failed to obtain tangible results by attempted use of soft power, China has been increasingly using a combination of hard power and sharp power. Before setting out to define them, we should remember that China has been using three specific methods in its attempts to redistribute power in the international arena. The first one is to achieve an internal balance required for its relations with the rest of the world led by the United States. It refers to the rapid buildup of its military capacities. Chinese arms race with the United States and its allies in the region is more than obvious. The second method includes achieving an external balance which includes creation of political and military alliances against hegemons. This is where China has not been doing particularly well. At the moment, it cannot boast of a long list of client states ready to follow it wholeheartedly (North Korea, Zimbabwe, Venezuela and Cambodia are some of them). And finally, the third method refers to the soft balancing by using non-military means aiming at redistribution of economic and political power.

As part of the economic segment of soft balancing, China has been intensively using the offensive tools of geo-economic arm-twisting such as banning traveling and issuing visas to the citizens of certain countries (Taiwan and South Korea), banning import and export of strategic raw materials or products (Japan, Australia, U.S.), limiting export and import by raising tariff rates or using other, non-customs barriers, suspending payment of developmental or humanitarian assistance, denying payments of agreed loans, inciting public boycotting of foreign products (Japan and U.S.) and suspending diplomatic communications. On the other hand, the defensive tools of the economic segment of soft balancing include the moves like creating exclusive economic blocs (RCEP), diversifying import or export, trying to reduce the dependence on the US dollar in international trade and investment, diversifying import and export energy pipelines and building alternative regional/multilateral institutions (AIIB). And finally, China is very active in the political segment of soft balancing, which implies interfering in the domestic political processes of other countries despite its declarative support for the principle of non-interference in the internal affairs of sovereign countries. It also tries to manipulate the global public opinion against the image of particular countries not toeing Beijing's line. The abovementioned examples indicate that China has been trying to increase its hard power that rests on the elements of arm-twisting in the context of internal, external and soft balancing.

On the other hand, China has also been using a relatively new concept of sharp power, the relevance of which has increased in the digital era. Sharp power usually refers to attempts of censorship and manipulation intended to undermine the integrity of independent institutions of liberal democracies. This power is called sharp because it penetrates the political and information environments of the targeted countries. In addition to interventions in democratic processes such as Russian misinformation-spreading campaign during the 2016 election in the United States and the election for the European Parliament, sharp power has other forms of eroding effects on liberal democracies. From the perspective of authoritarian regimes, suppressing freedom of expression, generating fake news and nurturing the narrative that promote authoritarian values and alleged efficiency of authoritarian regimes is crucial for determining the long-term perception of the world of the citizens of democratic countries.



While China has not yet become known as an authoritarian power which intervenes directly in the electoral processes of the rival countries, its actions (as specified in the Freedom House report entitled *Beijing's Global Megaphone*) are becoming increasingly dangerous even for the consolidated and strong liberal democracies, to say nothing of the ones that have not achieved such a degree of political development. China's audacity in using sharp power is perfectly illustrated by the following statement of Xi Jinping: "Wherever the readers are, wherever the viewers are, that is where propaganda reports must extend their tentacles" (Cook, 2020:1).

To illustrate this, China is using several specific "sharp power" tools:

1. Misinformation-spreading campaigns on social networks and manipulation with search results on global network platforms.
2. Pressure on media and journalists (the recent expelling of American journalists from China and attacks on local journalists and critics from the user accounts on Twitter and Facebook opened for this purpose by Chinese embassies in host countries).
3. Beijing's control over crucial parts of the information infrastructure of particular countries – because Chinese technological companies with Party ties build or take over platforms for dissemination of contents intended for millions of media users abroad.
4. Chinese officials taking targeted steps in order to present China as a role model for other countries; the steps include organizing training and education for the staff and heads of numerous foreign organizations, and transfers of technology to media companies abroad.
5. Attacks on freedom of speech coupled with threats of economic sanctions (for example, after Daryl Morey, general manager for Houston Rockets basketball club, supported the protesters in Hong Kong in his tweet, China strongly attacked the Rockets and threatened NBA with a loss of billions of income in the Chinese market).
6. Self-censorship in order to avoid losing access to the market (soon after Chinese threats of losing access to the Chinese market, Australian publisher Allen & Unwin withdrew a book condemning Chinese influence in Australia).

## EU AND THE ROLE OF TRADE POLICY AS A RAMPART AGAINST THE ADVANCING AUTHORITARIAN VIRUS

If one observes China from the EU perspective, one often gets the impression that the EU economies are critically dependent of the trade and investments between Beijing and Brussels. But this prevailing perception does not quite correspond with the facts, although the bilateral trade had grown eightfold since 2000 (Zenglein, 2020). Indeed, China is the EU's leading trade partner; the overall bilateral trade makes up 14% of the EU's overall trade with the world. But if we observe only the EU export and the jobs depending on it, the American and British markets are twice more important than the Chinese. Also, if we take into account the overall trade of all EU member states, then the share of the trade with China accounts for only 8.7% (Eurostat NewsRelease, 2021).

Besides, in case of a trade conflict between individual EU member states and China, the member states that find themselves under Chinese economic sanctions have a much larger degree of freedom than they think. A number of times in the past, China sanctioned the countries condemning blatant violations of human rights in China. We should mention here Australia, Canada, Norway and Sweden. Regardless of the diplomatic sanctions and restrictions or boycotting of their products, the effects of Chinese economic sanctions are often exaggerated. Press reports often dramatically underline the economic damage caused by the restrictions imposed, forgetting that the relative share of the threatened import in the overall export of the said countries ranges from 0.3% and 2% (Patey, 2021). Also, in the past, Beijing has tried to achieve its diplomatic goals with very limited sanctions accompanied by exaggerated PR, aware that China itself depends on the import of critical products. Unfortunately, its PR was often efficient, because many countries that were not under sanctions reacted opportunistically and filled out the gap thus created, so the Chinese “divide and conquer” strategy often gave results.

If we analyze the investment flows, we will find out that, in 2019, the EU received overall cumulative foreign direct investments (FDI) of more than USD 11.27 trillion. At the same time, it received cumulative FDI of approx. USD 100 billion from China – less than 1% of the overall such investments (Statista Research Department, 2021; Textor, 2020). This volume of FDI from China is infinitely smaller than the volume of FDI from the U.S. As for the cumulative

FDI from the EU to the U.S., their volume is as much as 15 times bigger than the volume of such investments in China (Gros, 2021). Clearly, based on an analysis of export and incoming and outgoing FDI, China is still much less important for the EU than its traditional allies the U.S. and Great Britain. Besides, Chinese market is not an Eldorado for European companies anymore, as can be seen from the increasingly weak position of German carmakers there. Chinese competitors such as Geely and Changan started taking growing market shares and the operating income of the German companies has been declining in the past five years. Contrary to it, the European market has recently generated a growth of income larger than the Chinese market (Patey, 2020). Given the above observations and the abovementioned restrictions to foreign direct investments, the level of European FDI in China was reduced by half between 2011 and 2018 (from EUR 15 billion to EUR 8 billion per year). Chinese strategy Made in China 2025 is yet another problem for European and American companies. The goal of this strategy is to ensure China's self-sufficiency in ten industries of the future identified by Chinese Communist Party (artificial intelligence, electric vehicles, semiconductors etc.). The strong support to Chinese manufacturers is supposed to ensure that they achieve 80%-control of the market by 2025. Naturally, the support includes not only lavish subsidies and credit lines, but also the strengthening of barriers to foreign competitors' access to Chinese market. Chinese electric vehicle manufacturers are required to use batteries produced in the factories that have operated in China for at least one year, thus eliminating Japanese and South Korean suppliers (Economy, 2018).

On the other hand, if we take into account the dependency on China as a "global factory", the coronavirus pandemic has created a feeling of emergency after the EU's dependency on the supply chains centered in China had become visible. Indeed, for many product categories imported by the EU, there are specific sectors and EU member states that strategically depend on the components coming from China. Strategic dependence is defined as a situation where the EU is a net importer of goods; the EU imports more than 50% of such goods from China, which has a global market share higher than 30%. In accordance with this definition, the EU was in 2019 in a position of strategic dependence for 659 out of 5,600 product categories included in UN Comtrade database (Zenglein, 2020). These goods accounted for 43% of the value of the overall import from China (idem.). On the other hand, a critical strategic dependence is created when there is a limited access to a product category that

could disturb entire economy or make it vulnerable, given the aggravated conditions for acquiring technologies and knowledge and an unfavourable cost structure for creating alternative supply chains. Crisis situations are when it becomes obvious that the adequate responses are preparedness for shocks and diversification of trade, not autarchy. For example, after the initial shortage of face masks and protective equipment in spring 2020, it soon became clear that the EU had the machines and materials required for their production. This was when Europe's strategic dependence on face masks stopped being critical. If we disregard the shocks, the EU's strategic dependence on the import from China is even lower. It is prominent in only 103 product categories such as electronics, chemicals, mineral raw materials, pharmaceuticals and medicinal products; most of these products fall into the technologically low-sophisticated segments of the supply chain (*ibid.*).

Clearly, the EU has much more in common with the U.S. as its traditional economic and security partner than with China. Not even Donald Trump administration managed to affect the intensity and importance of these ties.

This is why it is hard to understand the haste of some European leaders, headed by Angela Merkel, to negotiate the Comprehensive Agreement on Investment (CAI) with China, despite the U.S. administration's message to the EU to wait until Washington and Brussels coordinate their joint attitude towards the China-related issues that have been a source of discontent for years. China has repeatedly turned out to be a partner willing to violate written agreements when they do not suit them and the EU is now risking a large portion of its credibility (Beatie, 2021).

The CAI – and the recently signed RCEP (Regional Comprehensive Economic Partnership)<sup>22</sup> – are good examples of shallow economic integration that fails to address the fundamental problems that China's trade partners face – such as government subsidies, limited access to public contracts, problems in settling disputes between corporations and the government, and in improving workers' rights and environmental standards (Babones, 2020a; Cutler, 2021; García-Herrero, 2021). On the whole, by signing and ratifying the CAI, China wants to achieve an additional influx of FDI in the conditions of a slow economic growth and ensure access to the European market in the era of growing

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<sup>22</sup> RCEP is made up of 10 ASEAN members and Australia, New Zealand, China, Japan and South Korea.

protectionism. On the other hand, EU companies have been given some concessions: the obligation to transfer technologies and to enter joint-ventures with Chinese companies when entering the Chinese market has been abolished and access to some sectors that have been closed or restricted for foreign investors (such as health care) has been enabled. Still, China gained more, because the agreement does not ensure full reciprocity for the European companies accessing Chinese market. China also made political gains, because it won the first round of its competition with the U.S. by de facto weakening the transatlantic cooperation.<sup>23</sup> Contrary to European Commission president Ursula von der Leyen's initial announcement that one of the priorities of her mandate would be to build a "geopolitical Commission", this agreement negotiated with China has challenged such ambitions.

It is safe to conclude that such decisions will not help the EU justify its status as one of the global leaders of liberalism, particularly if a large part of German economic and political elites will keep believing naively in the maxim *Wandel durch handel* ("transformation by trade" in German) or if part of European elites will nurture disoriented liberalism. This is best described in the saying of German billionaire Jürgen Herhaus: "We can't judge the Chinese according to our standard of values, or our cultural or humanistic ideals. They simply function differently and even have a different relationship to life and death" (in: Karnitschnig, 2020). This is why Germany is somewhat hypocritical when it stalls with ratification of the EU-Mercosur free trade agreement on account of Brazilian president Jair Bolsonaro's deforestation policy, while at the same time it has no problem signing the CAI without insisting that the Chinese stop using forced labor in concentration camps and that they adopt the fundamental documents of the International Labor Organization.

Fortunately, not everything has been agreed on in this episode of trade negotiations. The unsatisfactory results for the European side should be thoroughly examined during the ratification process. Of particular importance

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<sup>23</sup> The EU must insist on reciprocity. This is the only way to secure a ground on which European and Chinese companies will be able to compete in the long run without discrimination. The same argument applies to the civil society sphere. Restrictions on freedom of speech and on founding of non-Chinese civil society organizations in China are good enough a reason for preventing the similar activities of the Chinese organizations abroad sponsored by the Chinese government. Sweden did the right thing when it closed the last remaining Confucius Institute on its soil. Other member states should follow this example if Chinese pressures and blackmails continue to grow.

here should be the European Parliament and smaller member states, the interests of which were neglected by German and French negotiators in their attempt to reach a rapid agreement. In the post-pandemic period, China will experience an economic slowdown and will need access to the EU market in order to ensure growth even more than has been the case.

Contrary to what Kishore Mahbubani, an Indian-born professor based in Singapore (2020), claims in his book *Has China Won? The Chinese Challenge to American Primacy?* – that future globalization will be led by China and not by the United States – we should point out that the future of growth will primarily be Asian. In this respect, strengthening of trade and investment connections such as recent free trade agreement between the European Union and Vietnam or the ongoing negotiations on the same type of agreement with Indonesia and India offers precious diversification options in relation to the Chinese market when we talk about import and export of goods and services and lower exposure to the tools of economic pressure. The EU, as the world's biggest economic power with 46 regional trade agreements with more than 50 countries, can and should become the embryo of a large coalition of liberal democracies which is to ensure domination of multilateral solutions and institutions, avoiding any attempts of political instrumentalization of the existing asymmetry in the economic relations.

Thus, the European Union is in a position to both protect its economic interests and be a principled advocate of the enlightenment values it rests on. Keeping in mind the strengthening of China's sharp power and its tendency to ever bigger self-sufficiency, liberal democracies will have to work on joint solutions, such as developing their own solidarity-based measures targeted against Chinese sanctions. Three potential solutions feature prominently. First, establishing a joint fund on the EU level (and potentially beyond it), that would compensate the damage suffered by the companies facing Chinese sanctions. Every country would collect insurance premiums from its own companies doing business with China, depending on their exposure to the Chinese market, in order to avoid moral hazard and protect the taxpayers' money. The newly established Freedom Alliance Fund would very accurately define China's economic arm-twisting and determine whether conditions have been met for making payments (Oya, 2020). Second, the EU, U.S. and the countries of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) should work together on reforming WTO and/or developing parallel

solutions for stricter and more accurate definitions of acceptable government subsidies and exemptions from WTO standards when national security is in question. Unfortunately, at this moment, all Chinese companies that receive substantial government subsidies can apply to public calls for proposals financed with EU money, while at the same time the EU competition policy imposes strict limitations on government subsidies when it comes to the companies based in the single-market countries. Third, the EU could use the latest legal tool passed in December 2020 – the European Magnitsky Act. Magnitsky legislation refers to laws providing for governmental sanctions against foreign individuals who have committed human rights abuses or been involved in significant corruption. Freezing the bank accounts of the Chinese citizens involved in these practices or imposing travel bans on them would certainly lower the intensity of Chinese sharp power. This is the right path for the EU to go in defending its core values, as shown by the latest spat between the EU and China, which also galvanized other liberal democracies such as Canada and Great Britain to take the EU's side after China had imposed severe counter-sanctions on several Members of the European Parliament and European think-tanks. Namely, EU had referred to the European Magnitsky Act and imposed sanctions on Chinese officials over Uyghur repression. As things stand in the early April, current escalation of events stands a good chance to achieve two goals at the same time. First, the CAI's ratification will stall and the deal will have to be substantially renegotiated to alleviate major concerns over severe breaches of human rights in China and nonreciprocal distribution of gains to the disadvantage of the European side. The latter modifications to the current deal are hard to imagine given China's uncompromising stance. Second, this is a turning point in the EU-China relations because it offers a great possibility for bringing closer together the positions of key liberal democracies on both sides of the Atlantic concerning the challenges posed by the authoritarian China.

#### TECHNOLOGY AS A WEAPON IN SERVICE OF AUTHORITARIAN REGIMES

Finally, in the global regulation of the Internet, a resolute stand should be taken against the Chinese authoritarian regime's increasingly intensive use of sharp power. The Internet regulation disputes constitute a new domain where



economic and political power will be manifesting itself in the 21st century, as is suggested in Laura DeNardis' book (2014) *The Global War for Internet Governance*. In the past couple of years China has aggressively promoted a new global Internet regulation model under the auspices of the International Telecommunication Union (ITU) – a model which is later usually adopted by governments across the world. This particularly refers to the governments of developing countries which are in the process of building their digital infrastructure. A consortium led by Huawei and Chinese state telecommunication companies such as China Unicom and China Telecom has been lobbying intensively for introduction of new Internet protocols called New IP. Such transformation would mark radical reorganization of the Internet, introducing top-down control instead of current, relatively anarchic but free Internet organized on the bottom-up principle. (Murgia and Gross, 2020).

The Chinese governance model, spiced up with the futuristic pictures of self-driving cars and the Internet of Things, would enable the governments of the countries adopting it to have full Internet access control applied to their citizens, inspired by the Chinese model. In practice, this would mean that every individual would need their service provider's permit for any activity on the Internet, be it downloading of applications or accessing particular websites. Of course, such an approach would bring online censorship and self-censorship to a whole new level around the world, thwarting freedom of expression. The threat could be even bigger if Chinese network operators were in a position to control critical infrastructure in other countries. In that case, the vision of a unified and free Internet would be replaced by a fragmented Internet that would put wind in the sails of the global authoritarian virus – or what the official Beijing euphemistically calls cybernetic sovereignty. However, as China's economic and political interests will be increasingly directed outside Chinese borders, following the logic of a great power's behavior, so will cybernetic sovereignty remain exactly that – a euphemism serving for projecting China's sharp power and defending its authoritarian values.<sup>24</sup>

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<sup>24</sup> We should also reiterate that the current Internet regulation model within the ITU has more advantages than the Chinese proposal, despite some shortcomings, such as the challenge of making the Internet open and widely available while still being governed without disturbance by private companies. Also, a better-quality regulation model will have to be offered in the long run, but the advantages of the existing system should be defended in the meantime. If this does not happen, more and more developing countries will gravitate towards the Chinese Internet regulation model, thus weakening the immune reaction of the rest of the world – liberal



It is very important that Western liberal democracies find an effective common denominator in order to respond to China's technological expansion. Donald Trump and Mike Pompeo used an aggressive approach to promote giving up the cooperation with Huawei, making no promises and announcing no incentives for the countries supposed to sacrifice their access to the competitive and high-quality supplier of 5G telecommunication equipment because of the security agenda. In 2020, the U.S. launched the 5G Clean Network initiative supposed to ensure a secure communication channel which did not use any data transmission, control, calculation and storage equipment coming from unreliable IT suppliers obliged to cooperate with Chinese Communist Party. In late 2020, as many as 17 EU member states joined the initiative, together with numerous non-EU countries like Great Britain, Serbia, Ukraine and Albania (Radio Free Europe, Radio Liberty, 2020). Some other countries, like Germany, Italy and Spain, did not join the initiative; instead, they announced using of the common EU 5G tool framework and strengthening the regulation in order to eliminate unreliable suppliers. This framework urges a coordinated approach to the implementation of the 5G network on the level of individual states and the Union. The crucial problem here is the ambivalent attitude of German chancellor Angela Merkel, who has not resolutely supported the initiative, despite the pressure from her own party, from the coalition partner SPD and from the opposition (the Greens and FDP). Instead, Germany is sheepishly using the political strategy of "hedging" in its foreign policy. In the meantime, Huawei is creating "facts on the ground" in Germany. German IT security bill does require somewhat stricter criteria for 5G suppliers, but it insists that all German regulatory bodies must agree on elimination of unreliable partners in not more than 30 days, which is very hard to expect because this debate has been going on in Germany for two years without any consensus in sight (Thomas, 2021). On the other hand, Germany decided last year to allocate EUR 2 billion for the research of O-RAN telecommunication architecture which breaks down the telecommunication infrastructure to smaller components that offer better security and flexibility.

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democracies included – to the authoritarian virus. Chinese moves in the Internet regulation domain support the thesis that the Party has switched from defensive to offensive moves in its propagation of authoritarianism. Nevertheless, liberal democracies possess more than enough capacities to fend it off. However, they should increase their awareness of this authoritarian virus beforehand.

Germany's desire to reconcile its economic interest and security is understandable, but endless gambling on hedging is not a long-term option, given the abovementioned "facts on the ground" (the rapid growth of Chinese infrastructure) and Biden administration's intention to establish closer cooperation with the EU about this issue. As much as some of German leaders would like to believe in the possibility of remaining neutral in the dual collision of two technologically different visions of the future of telecommunication market offered by the U.S. and China, it is simply not an option. Germany should therefore begin shaping the technological agenda together with its transatlantic and European partners. Increased joint allocations for research and development of 5G solutions can enable Germany and the EU to get a share of the fast-growing telecommunication market and ensure security at the same time. New competitors in the area of 5G network, such as Samsung, can help them with it in the transitional phase. The growing geopolitical uncertainty has enabled Samsung to expand its core business (mobile phones) and take a substantial share of the global 5G market (White, 2020). In addition, the cooperation with the U.S. on the global regulatory standards in key regulatory bodies for 5G technology (such as 3GPP – 3rd Generation Partnership Project and ITU), cooperation with 5G equipment manufacturers such as Samsung, Ericsson, Nokia, and those that are still trying to become part of their supply chain, can significantly improve European economies' competitiveness (Xu, 2021). In this respect, we should remind on the words of legendary Werner von Siemens: "He who owns the standards, owns the market."

Having realized this long ago, Chinese Communist Party has been on the offensive on the key international regulatory agencies in the past years in order to influence new standards in numerous sectors, from consumer electronics to artificial intelligence (Kynge and Liu, 2020). This is why liberal democracies must act fast and with resolution in order to prevent even deeper division of the world on two digital blocs and not to lose current geopolitical advantage if China lays even greater stress on exporting its authoritarian virus. Preventing China from obtaining platforms that would facilitate its attempts to shape up an international order safe and cozy for its authoritarian values is an equally important imperative (Ferguson, 2020).

Clearly, Communist Party's ambitions won't stop on China's borders. It has already started exporting the concept of "controlling state" to the rest of the world, directly or indirectly (Brands, 2020). This is why liberal democracies

should not perceive China's technological progress only in terms of its current applicability in the domains of defense and national security, although Beijing has a long-term intention to achieve an almost full fusion of research and application of technology in civil and military spheres (Weinstein, 2021). Actually, China's technological progress poses a much bigger challenge than is usually thought because it is not focused only on gaining the advantage on the conventional battlefield; it redefines the battlefield as such. Commercial technologies such as 5G network, quantum computing and biotechnology make it possible to gain domination without firing a single shot. The infrastructure harnessed into a wider political agenda is no mere infrastructure, but an instrument of economic and political control. As such, it functions as Trojan Horse (Darby and Sewall, 2021).

Let us take the example of China's progress in the area of *fintech*, in the context of the Party's ever-stronger bear-hug on the business decisions of the nominally private Chinese companies like ZTE, Alibaba, Tencent or Huawei. Billions of terabytes of Internet traffic and search histories, bank transactions data, data obtained by facial recognition technology, geolocations and social network links will make it much easier for the Party to deny or freeze assets on bank accounts or simply use the information thus obtained for shaping its political agenda (Schadlow and Kang, 2021). Besides for strengthening the "controlling state", the expansion of trade and investment relations can also be used as a means of asymmetric dependence and, consequently, of political pressure on other countries ("sharp power"). This process can also lay the foundation for challenging the US dollar and euro as the key reserve currencies in the world by issuing a digital renminbi. Let us not forget what Robert Mundell said: "Great powers have great currencies." This will be discussed briefly in the following chapter.

Actually, corona crisis made the rest of the world realize that technology, economic arm-twisting and corruption will be the main tools of Chinese foreign and economic policies (Brands, 2021). While economic separation of China from the West would be a strategic mistake, reducing the dependence of democratic societies and their business subjects on Chinese technology, money and market is a strategic imperative. But the only way of achieving it without having to pay an excessive economic price is to increase coordination and integration of policies. An excellent example of this is the recently established cooperation between Australia, the U.S. and Japan on reducing their

companies' critical dependence on Chinese deliveries of "rare metals" such as neodymium, lanthanum and cerium, indispensable for electric vehicle industry and highly sophisticated technological products such as F-35 fighter. At the moment, China controls more than 85% of the global market and has repeatedly threatened to stop the delivery of "rare metals" (Smyth, 2020). The abovementioned cooperation is very important because it enables Western companies to split the high cost of "rare metal" processing (such cost is lower in China due to more flexible environmental regulations, government subsidies and economies of scale). As the aspect of security will become more important than the very low price of input, the joint creation of a competitive raw materials base is a precondition for maintaining technological superiority.

With this in mind, the U.S., EU and other allies will have to redesign their innovation ecosystems and spruce up their own technological solutions for the new digital era, the solutions enabling better balance between economy and democratic qualities. For it is an illusion to expect that, in the long run, only control of the export of the sophisticated equipment such as semiconductors or aircraft parts to Chinese market will help maintain the relative advantage of Western companies and societies. It is just a small part of the solution that could stop the spread of the authoritarian virus by buying precious time for their own transformation (Smith, 2020).<sup>25</sup> Along these lines, Martin Wolf (2021) is right in claiming that the U.S. and EU cannot isolate China because it is much more developed and networked than the Soviet Union once was. That would imply huge economic and political damage. What liberal democracies can do, though, is to organize a "big cleaning" of their own house – in other words, fully revitalize their democratic systems and economies.

## THE DANGER OF BOTH WEAK AND STRONG CHINA

Numerous critics have pointed at the fact that China has not been particularly eager to export its values like the United States during the unipolar moment

<sup>25</sup> China is still technologically inferior to America, Europe and Japan when it comes to such sectors as semiconductors and commercial aircraft (Babones, 2020b). But in a world where bans and sanctions are often porous, bans are not an efficient way of maintaining technological advantage. The only answer to this problem is a combination of better R&D policies and prevention of dependence on Chinese infrastructure which could facilitate industrial espionage and sabotages.

in the history of mankind, in the 1990s and early 2000s. Others will say that China does not have a model that would be popular enough to be applicable outside its borders nor it has the capacity to promote it throughout the world. They primarily mean that China lacks the ability to replicate its experience in other states and that it lacks soft power. Regardless of their true motivations, Chinese moves reveal a state of strategic schizophrenia. On the one hand, there is no better proof of China's insecurity than the conviction of its numerous ambassadors and diplomats that the tweets and posts of the citizens of liberal democracies on the other side of the world threaten the political stability and legitimacy of China's order in the eyes of Chinese public. On the other hand, the best proof of China's excessive confidence in superiority of its authoritarian model is the deep conviction of their leaders that it is up to them to determine the limits and contents of political discourses in democratic societies (Brands, 2020). Be it as it may, regardless of whether the Party, at this stage of development, has already decided to support actively the export of authoritarian political capitalism and achieve first regional and then global hegemony or it only aims at shaking up the ideas underpinning liberal democracies in order to buy itself a few more decades of undisturbed rule, one thing is very certain.<sup>26</sup> In both scenarios, China poses a threat to the values of liberal democracies. The overconfident or underconfident eyes of the Party power-wielders in Beijing are simply not good for the rest of the world. The worst strategy against the authoritarian virus would be a gradual convergence of the political and economic institutions of liberal democracies towards the institutions of political capitalism and cyber-dictatorship. This would mean losing the battle even before it has begun because, in liberal democracies, it is the citizens that represent the first line of defense, not their governments. In the era in which the horsemen of the apocalypse are raising their heads, the solution is in strengthening, not in weakening the citizens and their democratic institutions. The same principle applies to the reforms that strengthen the legitimacy and efficiency of market outcomes instead of actively undermining them. And last but not least, the existing multilateral institutions should be strengthened and new ones built, while retaining the network of alliances and mutual solidarity.

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<sup>26</sup> Many claim that the purpose of Chinese attempts to weaken the Western liberal democracies is primarily to delegitimize their values in the eyes of "Chinese audiences" because these values could threaten the Party's leading political position among these audiences.

## FINAL LESSONS FOR STRENGTHENING LIBERAL DEMOCRACIES

### COMING TO GRIPS WITH CHINA'S TWO CRUCIAL TROPHY PROJECTS

We said in the previous chapter that the challenges liberal democracies are facing should be dealt with by strengthening the citizens and their democratic institutions, together with the reforms that strengthen the legitimacy and efficiency of market outcomes instead of undermining them. The first line of defense of democracy is always on domestic soil; this is what enables liberal democracies to acquire strong immunity against the authoritarian virus. Only then comes the second line of defense, which implies active responses to China's attempts to strengthen its own power over other countries, as opposed to a desirable scenario in which China strengthens its own power and joins it with the power of other democratic countries for the purpose of dealing with global problems together. There are two major "trophy projects" that constitute part of China's efforts to strengthen its power over other countries: the foreign-policy initiative Belt and Road and the internationalization of the renminbi. Before we embark on a detailed analysis of the first line of defense of liberal democracies, we should briefly summarize the weaknesses of China's foreign-policy initiatives and suggest the moves liberal democracies should insist on in order to make the world safer from the authoritarian virus.

Analyzing these initiatives in detail is beyond the scope of this book. We will just mention here some of their major weaknesses. China is still far from identifying itself with Nobel Prize laureate Robert Mundell's famous epigram, "Great powers have great currencies". This will remain so until China liberalizes its capital account of balance of payments and allows for better protection of ownership rights, improves its financial regulation and establishes independent judiciary. Only this will attract large numbers of foreign investors to

the Chinese financial market. Only then will they have enough confidence to keep substantial amounts of yuans in their portfolio, while China will have an opportunity to receive foreign financing in the currency the supply for which it will be able to control. Of course, the price the Party would have to pay would be giving up the financial repression policy as a tool for controlling and directing national credit flows according to political needs and accepting the higher risks arising from freer cross-border capital flows. The latest initiative of Chinese central bank (PBOC) to launch the “digital renminbi” project will not change the huge discrepancy between the fact that, in 2019, China accounted for as much as 16.4% of the world’s GDP and the fact that its currency accounted for merely 1.9% of the world’s cross-border payments at the same time (Kärnfelt, 2020). Embarking on the road to a digital renminbi in international payments would require *de facto* departure from the key determinants of the Chinese political capitalism discussed in the previous chapters. Closely related to it are the problems that Belt and Road Initiative has been facing. As China does not have a widely accepted international currency, its economic expansion abroad has to be financed with foreign currencies, primarily the US dollar. It is estimated that as much as 85% of China’s foreign loans are denominated in US dollars and the remaining part in the renminbi and other currencies (Horn et al., 2019). China is facing risks and limitations because of its dependence on foreign currencies. One of them is that it may be forced to stop its foreign investments and implementation of infrastructural projects because of potentially growing debt servicing costs and exchange rate risk. This is very accurately described in the words of a high-ranking China Exim Bank official: “If African borrowers don’t pay us, we still have to pay our bondholders” (in Brautigam, 2020). On the whole, a power on the rise which cannot finance itself with its own currency and which increases its foreign debt is facing a risk that foreign companies and institutions will not be so keen on accepting its currency.

The huge advantage of the U.S. – the fact that it emits the world’s reserve currency – can be maintained by strengthening the independence of the American political institutions that suffered severe setbacks during Trump administration and by a measured use of economic sanctions as a foreign-policy tool. Excessive sanctions, including one of the toughest ones – denying access to SWIFT (Society for Worldwide Interbank Financial Telecommunication) – can definitely lead the targeted countries to try to find alternative channels



of international payments and to develop currencies for such payments. This would undermine the power of the U.S., the currency of which constitutes the backbone of the international financial architecture.

As regards Belt and Road Initiative, it is important to say that, between 2008 and 2019, Chinese financial diplomacy directed USD 462 billion worth of loans and grants to developing countries (the highest amount since 2013, when the initiative was officially launched) (Gallagher and Ray, 2020). But it started to face major challenges even before the pandemic. The pandemic only made things worse. Of the official bilateral debt burden of African countries, the debt to China accounts for 62% (Subachi, 2021). The maneuvering space for additional preferential credit to and debt write-offs for poorer client-states is limited by the sources and type of financing. Almost 60% of Chinese loans to developing countries are commercial loans, 20% of them are soft loans and the remaining 20% are of unknown nature (Chinese loans are often under a veil of non-transparency) (Horn et al., 2019). Also, some 60% of the loans are secured with collaterals such as oil wells or some other natural resources. Venezuela is a typical example here. In return for participation in the G-20 initiative for suspension of debts of 73 poorest countries in the world, China required that a hundred or so large-scale loans for infrastructure projects within Belt and Road Initiative be exempted from the suspension. Beijing's current viewpoint is that "soft loans" are not eligible for any write-off or rescheduling. This is additionally confirmed by the recent report titled *How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments*, published by a consortium of prestigious academic institutions (Gelpern et al., 2021). Most of the contracts envisage repayment for Chinese loans as a priority and ban borrowers' participation in the internationally coordinated debt restructurings. Besides, China is not a member of the Paris Club of creditor countries and, even when agreeing to write-off debts to the poorest countries, it insists on reassessment of every single loan instead on agreeing in advance to write-off a certain percentage of the loans. Clearly, past experience indicates that China is not particularly keen on writing off debts and that negotiating debt rescheduling with it is anything but simple (Brautigam, 2020). Indeed, China is a net-creditor with huge foreign currency reserves, but the option of debt-repayment moratorium is something different than debt write-off. In the following months, it is this lack of dedication to the deepening of the G-20 initiative that could cost China its reputation in the countries whose citizens still have the most



favorable perception of China. These are the developing countries that have been very dedicated to participation in Belt and Road Initiative. If we add to this the poor coordination of the initiative, proliferation of corruption, low return on investment and the political risks arising from investing in high-risk client-states, it becomes clear that, contrary to the myth of China's "debt trap diplomacy", the very initiative could become a huge trap for China itself.

Liberal democracies should not wait for internal contradictions of Chinese financial diplomacy to paralyze the expansion of Chinese hegemony of their own accord; instead, they should actively strengthen the pillars of multilateralism responsible for the anti-poverty campaign and for economic development. In this respect, we should mention here the increase of the financial capacity of Asian Development Bank, African Development Bank and Inter-American Development Bank. The countries like the U.S. and Japan should by all means join the institutions recently launched by China, so that they could work on raising credit-financing standards from within and prevent potential export of the authoritarian virus by means of development financing. Here we primarily have in mind involvement in the transactions of Asian Infrastructure Investment Bank (AIIB) and coordinating the positions of liberal democracies in this bank.

#### LIBERAL DEMOCRACIES AND THE IMPERATIVE OF POLITICAL REFORMS

Regardless of Chinese Communist Party's ambitions to make the world more authoritarian, liberal democracies should strengthen their first line of defense, which is even more demanding a process than grappling with the still insufficiently developed Chinese initiatives. While they may be demanding, the economic and political reforms that strengthen confidence, efficiency and legitimacy of the political institutions that epitomize the idea of freedom are far from being unfeasible. This is how the confrontation of liberal democracies and the authoritarian virus should be defined. Framing this as a clash of civilizations should be avoided because it could push liberal societies on the slippery ground of extremist ideologies. There are several crucial political reforms the implementation of which would significantly strengthen the social fabric of liberal democracies. Perhaps the most important among the political reforms

is the one aiming at diminishing the importance of money in the election process and reducing the towering inequality between those who can participate in the electoral process financially in order to create an opportunity for a disproportionate influence on the decision-making process and the people.

In the U.S., 0.01% of individuals with the highest income make 40% of all political donations to candidates and parties (Milanović, 2020). Such a distribution undermines the fundamental democratic principle “One man, one vote”, turning it de facto into a “one dollar, one vote” system. A study by professor Martin Gilens (2012) vividly shows it. The members of the U.S. Congress will rather discuss and vote on the issues relevant for the richest than those relevant for the middle class and poorer Americans.

On the other hand, election campaigns in European liberal democracies are not so money-oriented but their functioning is increasingly affected by very short election cycles, growing fragmentation of parliaments and extended periods required for forming governments. If these trends are coupled with the low level of competence of the elected political representatives, the growing dissatisfaction with the state of democracy in a number of liberal democracies comes as no surprise.

A study carried out by McKinsey Global Institute points at a historically short duration of terms of office in the G-20 countries, which affects the elected officials’ prospects to carry out their agendas. Of course, longer terms of office can also be a risk, because they increase the maneuvering space for corrupt and incompetent politicians (although it can be controlled by strengthening the anti-corruption framework and introducing preconditions for assuming an office, like having certain levels of competence and previous experience outside politics).

Dealing with this problem is of particular importance, given the growing percentage of professional politicians who have been in politics all their lives and have very little contact with the real world outside their never-stopping political campaigns. This risk can be controlled by introducing indicators linking their payments to realization of public policy goals, but with the claw-back mechanism in place, preventing laying too much stress on the short-term results and, consequently, ignoring long-term outcomes (Moyo, 2018). Last but not least, electoral systems should reflect new reality on the ground and stop serving as an instrument for undermining the political competition via active and passive gerrymandering that meets the needs of the ruling elite.

All the above constitutes general recommendations aiming to find the lowest common denominator of the problems most of liberal democracies are facing today. Still, every one of them should decide on its own how to optimize the structure of political competition that would balance between excessive dispersion and excessive concentration of political power and make sure that falling into the trap of tyranny of the majority or tyranny of the minority is avoided. The abovementioned political reforms are the ones with the potential to pave way to economic reforms that would create the outlines of “people’s capitalism”, more of which will be said in the sections below.

#### THE UNHOLY TRINITY OF GROWING DEBT, GROWING INEQUALITY AND DECLINING PRODUCTIVITY

When talking about necessary economic reforms, the burning issues of today – such as growing credit intensity of economic growth, growing inequality and declining productivity – should be underlined first and perceived as a whole. Atif Mian, Ludwig Straub and Amir Sufi’s recent study of a weighted sample of 14 liberal democracy found that, in the past thirty years or so, the growth of the income concentrated in the hands of the wealthiest 1% of the population has been followed closely by the growth of the overall debts of public sector and household sector, respectively (Mian et al., 2020). A similar study by Thomas Philippon and Ariell Reshef (2012) indicates that there is a connection between deregulation of the financial sector and the growing bonus earnings enjoyed by the employees in the financial sector (unlike the employees in other sectors). Of course, this connection between the growing debt and growing inequality can primarily be explained by growth of inequality as “bad” cholesterol, particularly in the U.S., the present-day capital of liberal-meritocratic capitalism. In their book *Winner-Take-All-Politics*, American political scientists Jacob S. Hacker and Paul Pierson (2010) show that growth of inequality is not an inevitable result of growing competition arising from participation in the trade globalization process and that the political lines of force such as growing influence of powerful interest groups on the political process are responsible for it. The financial sector blazed the trail in it by flooding the political arena with money. This type of inequality is in sharp contrast to the inequality functioning as “good” cholesterol, when inequality works as a catalyst of technological

progress and changes in social organization (such as growing urbanization in developing countries). The good type of inequality increases the overall wealth and indicates opportunities for growth to those lagging behind at the moment, provided that those who have already made it do not try unnecessarily to make it harder for those who haven't.

Elhanan Helpman (2018) from the Harvard University also offers an analysis with conclusions complementary with those of Hacker and Pierson. In his meta-study of the academic literature on globalization, he came to conclusion that globalization, in the form of free trade and moving production to countries with lower production costs, had not significantly contributed to the growing inequality. The point of this conclusion is that the globalization process does not make countries helpless; different economic and social outcomes in different countries can primarily be explained by actions (or lack of actions) of political elites in these countries. Some of these elites showed concern for helping the entire population adapt to new challenges and opportunities, while the others were too busy currying favor with their selectorate. So, just like bad cholesterol has negative effects on cardiovascular system, so does its inequality-related equivalent has injurious effects on the overall economy.

Bad inequality undermines economic growth in at least three ways: First, it narrows the range of talents, ideas and capital, as the wealthier ones tend to monopolize access to the best educational, social and economic opportunities. For example, at the leading 38 universities in the U.S., the share of the students coming from the households with top 1% of income exceeds the share of those coming from the households with the lowest 60% of income. According to economic estimates, access to top education at such universities is equivalent to receiving a USD 5-10 million inheritance (Milanović, 2020). Of course, not everyone can have access to such education because people are not empty slates with equal writing capacities. Still, providing equal opportunities for all those who do have such capacities is certainly essential for legitimacy of the whole system. In this respect, many European countries are in a much better position. It is important that, in the years to come, they retain their inclusivity and keep improving the quality of the educational process.

Second, to a large extent, inequality is both a cause and a consequence of a reduced level of market competition. In his latest book *The Great Reversal*, Thomas Philippon (2019) underlines the problem of the growing market concentration found in a number of economic sectors in the U.S. and of fewer new

shares quoted in the leading stock exchange indexes. This is also closely connected with declining number of new companies entering the market, which converges with the number of companies leaving the market due to bankruptcy procedures. The resultant of these two trends signalizes a dangerous decline of the entrepreneurial culture, particularly in the U.S. as its archetype. The powerful and politically networked companies often manage to squeeze their competitors out of the market or hinder their access to it. In this they have the backing of a favorable regulatory framework which increasingly reflects the quantity of time and money invested in promotion of narrow interests.

Connected with it is the absence of a reform of the corporate governance system. The absence of such reform has made it possible that the ratio between the pay of the executive director in an American company and the pay of an average employee grows continually. In early 1980s this ratio was 42 and in late 2017 it was 347 (Wolf, 2019). A similar trend is found in other countries, although less prominent.

The essence of all of the abovementioned factors not only leads to the breaking of the connection between productivity growth and wages, but it also impairs the innovation capacity and reduces the tax base from which the public and meritorious goods such as infrastructure, health care and education are financed.

Third, the stagnation or lagging behind of wages, combined with the questionable and inadequate structure of the income and expenditure sides of the public budgets of many liberal democracies, have a negative effect on the aggregate demand. This is why this demand increasingly depends on continued growth of debt. In his book *Between Debt and the Devil*, Lord Adair Turner (2015) points at the crucial problem in the years before the last global financial crisis, which became even more prominent in the years after the world's leading central banks had stabilized the markets by using unconventional monetary policy measures. The world level of debt continues to grow faster than the overall production; before the pandemic it reached the record-breaking USD253 trillion. Along these lines we should also mention a study by Stephen Cecchetti and Enisse Kharroubi (2012), carried out for the Bank of International Settlements. The study established that, when measured by the level of credits extended as against GDP, financial deepening increases economic well-being only up to a certain point, after which the law of diminishing returns

comes into action and the larger financial sector starts negatively affecting the overall productivity growth.

In their recent overview of the economic effects of the corona crisis, Charles Goodhart and Manoj Pradhan (2020) ask the key question: Can we reform capitalism without encouraging excessive debt every time when economic hardships hit the weak points of our economies? In principle, the answer is yes, because the system underwent a number of successful reforms throughout the history and chances are it would happen again. Market economies are much more productive, innovative, better in risk management and more efficient in allocating goods and services than any other alternative system which is not motivated by profit, private ownership and a decentralized price-setting process. Still, a constructive answer to the above question will require huge sacrifice, particularly when insiders in the existing system are concerned. The macroeconomic stabilization's problematic dependence on the growing debt of private sector can be reduced in two ways. First, governments can borrow more and more money and stimulate the aggregate demand – but this is merely a palliative instrument: sooner or later, the governments will not be able to repay the debt, thus inflicting large damage to the creditors, either by means of bankruptcy or by means of inflation. The alternative, on the other hand, relies on smart redistribution and strong protection of market as the key mechanism for resource allocation – all in order to create a more sustainable structure of the aggregate demand. Marriner Eccles, former chairman of the Federal Reserve Board, made the following point during a Congressional hearing long ago: “It is utterly impossible for the rich to save as much as they have been trying to save, and save anything that is worth saving” (in: Turner, 2015: 108). The defense of capitalism from the capitalists themselves begins with understanding the major difference between pro-market and pro-business attitudes and the fact that debt is the double-edged sword, as professors Luigi Zingales and Raghuram Rajan (2003) illustrate in their book *Saving Capitalism from the Capitalists*.

#### HOW TO TRANSFORM THE LIBERAL-MERITOCRATIC CAPITALISM INTO “PEOPLE’S CAPITALISM”?

There are several key steps to be taken to achieve the earlier mentioned redistribution and mitigation of the existing distribution conflicts. Given the

tendency that, in more developed and wealthier societies, the share of capital income grows as against the overall income, the redistribution should by no means imply reducing the capital share and perceiving “capital” as a class enemy, as is popular in some academic and political circles. Quite the opposite, the accumulation of capital and the income related to it is an inevitable part of the growth of wellbeing. However, to make it politically and economically sustainable, measures should be taken in order to reduce the inequality in the distribution of capital income. In his book *Capitalism, Alone*, invoking the concept of “people’s capitalism” first mentioned by Margaret Thatcher back in the 1980s, economist Branko Milanović argues for the reforms driving towards such type of capitalism. In addition to reducing the impact of money to the outcomes of the political process, Milanović also mentions bigger investments in more inclusive and better education, strengthening employee stock ownership plans, tax reforms that would exempt lower-income citizens from capital gains tax and encourage them to bigger capital investments, and introducing estate duties in cases of substantial inheritance, advocated also by one of the founders of economic liberalism, John Stuart Mill.

Unfortunately, Milanović’s book does not elaborate on the efficiency of these propositions, particularly in the conditions of the globalization and as regards differences in specific contexts (e.g. marked failures of some models of cooperative and employee stock ownership plan to achieve their announced goals). The evolution of capitalism as a complex adaptive production system as Milanović sees it are well-described in the first three columns in Table 3. The fourth column was added by the authors of this text. It presents the features of “people’s capitalism” compared to three other types (because Milanović failed to do it thoroughly). The key difference between the social-democratic type of capitalism and “people’s capitalism” is that the former is much less focused on income redistribution than the latter, which insists on a more egalitarian distribution of capital (in other words, *ex ante* as opposed to *ex post* redistribution). Too bad Milanović does not explicitly mention that the tax systems of liberal democracies should eliminate the unfavorable taxation of own capital as compared to debt financing. There are many ways of enabling transformation of capitalism and moving it from its liberal-meritocratic stage, which is, unfortunately, increasingly less liberal and less meritocratic. Introduction of a better tax system, more appropriate for the new digital era and the globalized world we live in, can enable not only the abovementioned redesign of the tax

system, but also weaker redistribution conflicts and dispersion of capital ownership. Also, taxation of excessive accumulation of debt and excessive lobbying can be dealt with by introducing new Pigouvian taxes to address the problem of negative externalities. The growing spending has made lobbying and election campaigns resemble an arms race and zero-sum games. Also, growing “debt pollution” of modern economies has deepened the disastrous cycle “financial instability – low interest rates – financial instability”. This is why these innovative types of taxation, if introduced simultaneously with reduction of other tax levies that stimulate entrepreneurship and creativity, have a huge potential for rejuvenating and strengthening liberal democracies.

Table 3

| Type of capitalism  | <i>Classical capitalism</i> | <i>Social-democratic capitalism</i> | <i>Liberal-meritocratic capitalism</i> | <i>“People’s capitalism”</i> |
|---|-----------------------------|-------------------------------------|--|------------------------------|
| 1. Growing share of income from capital in national income  | YES                         | NO                                  | YES                                    | YES                          |
| 2. High concentration of capital income   | YES                         | YES                                 | YES                                    | NO                           |
| 3. Individuals with significant capital are rich  | YES                         | YES                                 | YES                                    | YES                          |
| 4. Individuals rich because they own capital are also individuals who earn a lot from their own labor       | NO                          | NO                                  | YES                                    | YES                          |
| 5. The rich marry the rich (homogamy)   | IN SOME MEASURE             | NO                                  | YES                                    | IN SOME MEASURE              |
| 6. High correlation of income of parents and their offspring (intergenerational transmission of advantages) | YES                         | IN SOME MEASURE                     | YES                                    | IN SOME MEASURE              |



*Source: Branko Milanović (2019); with an addition by Kristijan Kotarski*

## COMING TO GRIPS WITH “FISCAL TERMITES”

“Fiscal termites” is the term used by economist Vito Tanzi (2017) for all the processes that, in the globalization era, erode the capacities of particular countries to collect taxes and ensure even distribution of tax burden. These include offshore financial centers, intra-company trade between local branches of multinational companies or new types of money (such as cryptocurrencies). The existing international tax system is largely obsolete, underlining the problem of fiscal capacity. By its structure, it is still oriented towards taxation of production factors which are much less mobile and lags behind an increasingly networked world of today. The widespread tax evasion practice used by leading multinationals has negative effects on the goals of economic efficiency and fairness. This is why the system requires a reform that would take into account the tax needs of both developed countries and developing countries. Tax competition is generally a good thing, but it should be placed into a framework with defined rules of the game in order to prevent an uncontrolled race to the bottom. An unrestrained tax competition leads to erosion of corporate income tax revenues, which obstructs production and makes it hard to maintain public goods on an economically efficient level. Also, paradoxically, it stimulates market monopolization because it changes the playground and rules of the game to better fit the well-established multinationals and ensure their advantage over their rivals and those who aspire to become their rivals. It is no wonder then that, in the past decade, large multinational companies managed to reduce their tax burden much more than other corporate subjects. In addition to the already explained negative effect on economic efficiency (erosion of public goods and reduced degree of market competition), we should mention here the negative effect on the perception of fairness. The multinational companies and their shareholders enjoy the benefits arising from the public goods such as security, judiciary, infrastructure, educated labor force and political stability – all provided by the leading liberal democracies. But financing of these public goods is increasingly falling on the back of less mobile and locally-oriented companies and consumers.

The multinationals can pull it off by using the system of transfer pricing between their local branches in order to register the profit in the jurisdictions

with very low tax burdens, by relocating intra-group debts for the sole purpose of reducing tax liability or by relocating intellectual property to the jurisdictions without taxes or with minimum taxes. Such a practice is possible due to unharmonized tax legislation around the world, particularly in the case of the companies where it is hard to establish the exact location of particular innovation, production or sales. As a case in point, in 2017, Facebook paid a tax of GBP 7.4 million in Great Britain, as compared to GBP 1.3 billion of income earnings (Ocampo, 2019). Brad Setser (2019) from Council on Foreign Relations showed that U.S. multinationals report 7 times more profit in tax oases (Bermuda, Luxembourg, British Virgin Islands, Ireland, Netherlands, Singapore) as compared to six biggest economies outside the U.S. (China, Japan, Germany, France, India and Italy). According to an IMF estimate from 2015, tax base erosion and relocation of profit reduced the long-term tax revenues of the OECD economies by USD 450 billion per year (1% of their GDP) and of developing countries by USD 200 billion (1.35% of their GDP). For the sake of comparison, corporate income tax revenues account for 2.9% of GDP of the OECD economies (Crivelli et al., 2015).

Strong international coordination could counterbalance these negative trends. The solution most in keeping with the intended reconciliation of the goals of economic efficiency and fairness would be to introduce a harmonized system of taxation of multinational companies. Their income earnings on the global level would be consolidated. The profit earned on the global level, together with the appertaining tax liability, would be geographically allocated on the basis of objective parameters such as volume of sales, number of employees, number of digital users in a particular country etc. Of course, a minimum corporate tax rate of 10% would be applied to the profit made. In this case, countries would be able to retain their right to introduce higher tax rates and the competition would not be eliminated, particularly if we keep in mind that the average corporate income tax rate in the OECD economies is 24%. The same principle applies to the offshore financial centers such as Caribbean islands, so aptly described by English writer Somerset Maugham's phrase "sunny places for shady people". According to some estimates, these centers enable state officials from around the world to receive illegally almost one billion USD of bribe – a problem that hits hardest the developing countries (Solheim, 2014). This conclusion is additionally strengthened by the IMF estimate that a sudden global increase in net errors and omissions in the international balances

of payments of its member states occurred after 2008 (Milanović, 2020). Illegal money flows have become considerable and corruption is a growing global challenge. The offshore financial centers still constitute an all too often ignored link in the corruption food chain.

Liberal democracies led by the European Union should ensure better coordination of their taxation of multinational companies on the basis of where these generate the cash flow and create added value. The OECD's Base Erosion and Profit Shifting is the first step towards detailed exchange of tax-related information between tax administrations throughout the world and 125 countries currently participate in it (Ocampo, 2019). But the second step of the harmonization of the corporate income tax system – the one that includes global consolidation of profit and harmonization of tax rates – is much more important and politically more difficult. Crucial here is an agreement between the U.S. and European Union that would also include coordinated introduction of digital taxes and regulation of online platforms. These issues were particularly controversial during Donald Trump administration, which did not have the slightest wish to reach compromise; Trump even said that, as far as trade was concerned, the European Union was even worse than China. In early 2021, the key question is how far is new Biden administration willing to go in order to reduce the market power of FAANG. The first step to be taken is forming the EU-US Technology and Trade Council that would deal with the said issues and enable achieving mutual benefit through some concessions by both sides. The U.S. would thus agree to the digital taxation and cooperation about the OECD action plan concerning Base Erosion and Profit Shifting (BEPS), while the EU would fully support the 5G Clean Network initiative and lower its tariffs on trade in goods, which are somewhat higher than the American tariffs. This is the way of strengthening the transatlantic “front” against the authoritarian ambitions of China and Russia. Good news on this front is the most recent statement by the Treasury Secretary Janet Yellen that the U.S. is now “working with G20 nations to agree to a global minimum corporate tax rate that can stop the race to the bottom.”

The second important example of the effects of fiscal termites is the pressure created by the uncontrolled migration flows that weaken the absorption capacity of the host country. This tension arises from the “impossible trinity” of the immigration policy – it is not possible to select all of these three elements at the same time: full-scale welfare state, multiculturalism and mass migra-

tions. The fact is, developed countries possess a higher level of social capital which implies confidence among the domicile population and confidence in government institutions. The immigrants from Middle Eastern, Sub-Saharan and Latin American countries, on the other hand, often bring with them a far lower level of interpersonal and institutional confidence. After a while, this situation begins to undermine the political support to the fiscal policy's redistributive function by means of erosion of public and meritorious goods (Kotarski, 2019). According to a large-scale Gallup survey, more than 750 million people throughout the world would change their places of residence if the migration process included no restrictions (Esipova et al., 2018). In view of the limited absorption capacity of developed economies and unpopularity of the option of closing the borders that would lead to huge loss of economic and social wellbeing, the propositions of the economists like Branko Milanović and Dani Rodrik tend to reconcile these tensions. They proposed that the nature of migrations be changed in such way that they resemble as much as possible the temporary work permits with no automatic or easy access to citizenship and to all of the rights arising from it.

Such a step would improve the economic wellbeing of the migrants by increasing the flow of people. The same conclusion would apply to the wellbeing of receiving states and emitting states. Also, with such a framework in place, the U.S., EU and other liberal democracies which are also destinations of mass migrations could additionally strengthen the long-term advantage over China and Russia. As these two countries are not attractive to potential migrants, the long-term technological and economic advantage of liberal democracies will continue to depend on attracting talented and freedom-loving immigrants. An excellent illustration of this is the case of the Turkish husband and wife Sahin and Türeci, who deserve credit for the landmark-discovery – anti-SARS-CoV-2 vaccine.

#### AVOIDING THE WORST-CASE SCENARIO: THE CONVERGENCES OF LIBERAL-MERITOCRATIC AND POLITICAL CAPITALISM

Should the key decision-makers in Western liberal democracies fail to address the problems of economic and political inequality, the liberal-meritocratic capitalism will not be threatened by socialism as one of potential horsemen of the

apocalypse, but primarily by its convergence with political capitalism. According to this scenario, economic elites would become increasingly isolated from the still nominally democratic societies, just as is the case with Chinese red capitalists today. The growing concentration of economic and political power threatens to create a negative balance dominated by elements of plutocracy, with occasional political breakthroughs of populist forces. If we can say that, in Chinese political capitalism, politics is a means of gaining economic advantages and power, the democracies in which elements of oligarchy are beginning to dominate will witness an opposite process – turning economic power into political power. And yet, regardless of these differences, the ultimate effect on political and economic freedoms is the same: their destruction by means of a closed circle of reproduction of the existing elites. This is particularly why the values of economic and political freedom should consistently be defended by persistent advocacy of the above described reforms. The coronavirus pandemic crisis adds crucial importance to such steps.



## **PART 3**

# **THE FIVE HORSEMEN OF THE APOCALYPSE**





## HOW THEY RODE OUT

It does not matter whether we speak about global strengthening of authoritarianism, internal weaknesses of liberal democracies or a combination of these two factors – it is clear that we live in the epoch of the rise of the horsemen of the apocalypse. This is not fatalism or a historical necessity. The pandemic and the reaction to it have made some threats more visible. The smell of totalitarianism is in the air. Still, Europe has enough time and intrinsic intellectual and political energy for finding answers even to the toughest challenges.

Strengthening of liberal democracy and finding new intellectual and political platforms for national and coordinated European responses to the pandemic are the tools required for promoting the European way of balancing individual freedoms and responsibilities. To preserve freedom as an achievement (the dramatic frailty of which was stripped bare by the European history in the 20<sup>th</sup> century), one must first be able to recognize the threats to it. We will analyze these threats in the remaining part of the book. There are five of them – the five horsemen of the apocalypse.

It is not just fear of the virus and disease. Interpreting fear is always complex. While some were afraid of the disease, others were scared of unemployment, impoverishment and their consequences caused by a radical lockdown. Yet another group was worried not about themselves but about their families. The fourth group was concerned about the human development and socialization of children who had suddenly stopped going to school although there was no evidence that children transmitted the virus more than adults. The fifth group felt threatened by the people who objected the stringency of the public-health measures because they thought dubious moral qualities were on the rise – readiness to sacrifice others for one's own freedom. Contrary to the fifth group, the sixth group felt threatened because others had taken the restrictions of dubious efficiency for granted, which made the former ones think they were surrounded with passive citizens to whom limitations can be imposed with no civic resistance, like in totalitarian regimes.

Fears are not subject to arithmetical operations. These are the fears of different people who live in the same society and it is primarily fears of other people

they are fighting against. In the times of the pandemic, we sought a magic social formula for the coexistence of different fears.

By observing the links between the pandemic on the one hand and economic and political changes on the other, one could notice the rise of five bad ideas, catapulted to the social surface by the fear of the coronavirus. These bad ideas are discussed in the text below: (a) “helicopter money” – the idea that the economic problems in the times of pandemic and the radical lockdown can be solved with distribution of fresh money; (b) “discredited European Union” – the idea that we are witnessing the end of the multinational framework of the international cooperation and exchange, which particularly refers to the European Union, allegedly discredited for failing to offer a common response to the crisis and help the most threatened member states; (c) “self-sufficiency” – the idea that the economic paradigm of the global capitalism is now giving way to reestablishment of national development frameworks, which allegedly represents a new opportunity, particularly for agriculture; (d) “nanny state” – the idea that reestablishment of the nation state as a political framework for the efforts to contain the virus will reincarnate socialism or an even more robust capitalism – state or political capitalism – as an institutional framework for the future economic and social development; and, last but not least, (e) “suspension of democracy” – the idea that China’s “success” in the fight against the virus shows that too much individualism and excessive reliance on the liberal model of civil control of government can threaten the survival during the pandemic, which is why new models of social organization should be considered, ensuring firm control and coordination from a single center and including collecting and processing of large quantities of citizens’ personal data.

These five ideas are closely connected. They constitute an entire worldview – a view at mankind and the future of Europe and Western civilization. This spirit – the one we describe by using the metaphor “the five horsemen of the apocalypse”, skyrocketed from the bottle during this crisis and send many Western liberal democracies dangerously balancing on the edge of autarchy.

As we pointed out in the first part of the book, the five horsemen ride neither fast nor in coordinated manner. One year after the outbreak of the pandemic, the horsemen seem less threatening than in the days of the first lockdown in March and April 2020. However, it would be naïve to think that the Pandora’s Box from which they emerged is now closed. The events from 2020 are a good opportunity to repeat the lesson that authoritarian ideas conquer the world

slowly, by gradually growing and moving from the zone of the unacceptable to the zone of the acceptable under the cover of panic and fear. When such a thing starts happening, it is useful to remember famous Austrian writer Stefan Zweig and his masterpiece *The World of Yesterday*, in which he says: “It is an iron law of history that those who will be caught up in the great movements determining the course of their own times always fail to recognize them in their early stages.” The following pages are a testimony of the early stages of the development of the bad ideas that were awakened in the times of the pandemic.

## HELICOPTER MONEY

This section is dedicated to the helicopter money – a belief that a special form of “printing money” can be used for solving the economic problems caused by the radical lockdown. Why do we underline that it is a special form of money issue? In the book’s second part, when writing about inequalities, we used the cholesterol metaphor. As there is good and bad cholesterol and good and bad inequality, there is also good and bad money issue. But they are hard to discern. Monetary doctrines are of no interest for us here since there are no universal recipes in monetary matters. What is of our interest here is telling good cholesterol from the bad one – being able to tell the good money issue, emerging when monetary policy can help mitigate the economic decline and leave the recession behind, from the bad money issue, emerging when monetary policy can cause excessive inflation and redistribution. Generally, bad money emerges as manifestation of deep disturbances in the political and monetary systems if it is used for disguised redistribution to the benefit of social groups with excessive power.

At one moment, at the very outset of the pandemic, in addition to the Chinese “radical lockdown” approach, helicopter money was also offered as a panacea for the economic consequences of the lockdown. A state that can do anything – for instance, lock people down indefinitely – can also print money and distribute it so that going through the uncertain lockdown will be more bearable. Such, at least, was the principal economic idea of the lockdown advocates.

Understanding the Faustian nature of some monetary instruments is of particular importance. While society is balancing on the edge because of widespread panic, “printing” of money may seem like a solution, regardless of potentially dramatic long-term consequences. This is why, in the text below, we will explain the concept of helicopter money, ways of its distribution and possible consequences.

A strict difference should be made between the short-term effects of expansionary monetary policy – some of which can be good – and the long-term effects, which can push societies over the edge of totalitarianism, coupled with other horsemen of the apocalypse. Such a combination is potentially explosive

and can change the civilization as we know it. In order to understand these mechanisms, first we have to remember the way the West dealt with the problem of high inflation in the 1980s.

#### HOW DID THE WORLD ACCEPT LOW INFLATION?

After dollar convertibility to gold ended in 1971, inflation became a worldwide problem in the 1970s and 1980s. Some countries, like the U.S., solved the problem in such way that their independent central banks raised interest rates in early 1980s (Volcker disinflation, see Goodfriend and King, 2005). However, in many countries, inflation persisted. In the countries with weak institutions, it even escalated. The hyperinflations and high inflations of the 1980s extended to South America, Southern Europe and the then socialist countries. Former Yugoslavia was collapsing economically and politically, and high inflation was part of that process – both its cause and its consequence. Croatia inherited from Yugoslavia the same monetary institutions and only in 1993 did it manage to break away from that part of its legacy (Šonje, 2018).

Simultaneously with the development of the inflation process and its solutions in the '80s and '90s, economists became aware of certain patterns on which modern monetary systems in the past thirty years have been based (Cukierman, 2007):

The countries that tamed the inflation earlier, entered the economic recovery period sooner;

The central banks of the countries that tamed the inflation suspended direct financing of governments and moved to indirect market regulation by targeting interest rates in money market and by occasional interventions in the secondary treasury bond market (open market operations). In this model, central banks influence the cost and quantity of reserve money. As for the transmission of monetary impulses through economy, it was left to the banks to decide autonomously who to lend excess reserves, at what interest rate and how much. Underpinning this solution is the assumption that financial intermediaries – risk assessment specialists – allocate credit better than governments. Governments perform allocations through state budgets, from tax revenues, not by controlling banks' business decisions, which they can influence only indirectly, through monetary policy and banking regulation.

The desired behavior of central banks (and the desired effects in terms of low inflation) are fastest achieved if central banks are independent: (1) in personal sense (parliaments appoint governors and the executive authority cannot replace them by political will alone), (2) in instrumental sense (no one can order the central bank what to do) and (3) in financial sense (central banks do not have to consult governments or parliaments for covering their operating costs – they are not part of the state budget). Germany's *Bundesbank* was at the time considered a global role model of independence and its institutional DNA was embedded in the institutional solutions for European Central Bank.

Research has shown that an annual inflation rate of around 2% maximizes the long-term economic growth. If inflation is below 2%, economy slows down or falls into recession. In that case, the central bank lowers the interest rates. In the opposite case it increases them, because if inflation exceeds 2%, it threatens to get out of hand and stir up disastrous inflation expectations that trigger people's reactions which are not compatible with development: for example, people expecting inflation quickly sell local currency and buy a more stable foreign currency, thus causing money to flow out of the circulation in the country. Consequently, inflation and inflation expectations are a sign of strong demand to which supply does not react.

## INTRODUCTION TO CRISIS: RETURN TO THE HELICOPTER MONEY CONCEPT

The above described consensus on central banks and their operations was possible because politicians saw a triple benefit in the arrangement with independent central banks. First, economic growth accelerated after the high inflation of the 1970s and 1980s was brought down. Second, government bond markets worked smoothly. Politicians could always find creditors or investors willing to lend to the government in order to finance the budget deficit. They did not need direct control over central banks anymore. Third, a suitable convenience occurred: for every trouble in economy, politicians could blame the central bank which makes decisions independently of the government. That fueled populist doubts about excessive power and independence of central banks. Central bankers accepted such implicit deal with politicians, being aware that,

when serving as the politicians' shield from the public, they were actually ensuring their own independence and autonomy in decision-making.

In America, where capital market is large and powerful and many people invest in stocks, a new phenomenon has occurred. It wasn't just inflation and (un)employment that Alan Greenspan, the charismatic governor of the central bank (Federal Reserve Bank – FED) who led the bank from 1987 to 2006 was paying attention to. He also reacted to the prices of financial assets – stocks in particular. Such policy was not unfounded and did not exceed the legal mandate of FED. Contractions of stock prices preceded recessions. This is why early reaction to excess fluctuations of asset prices in capital markets can stabilize economic activity. However, Greenspan was more concerned about the phases in which asset prices fell than about those in which they grew. Over time it became known as “Greenspan put”. It refers to FED reacting with expansive monetary policy if stock prices suddenly fall; monetary restriction is less likely if the prices of assets grow. This is important to remember because Alan Greenspan's intellectual legacy is still applicable, despite the fact that his reputation subsided after the crash of 2008. The corona crisis confirmed that central banks were ready for radical reactions when stock markets were falling but tended to be bystanders when prices of assets were growing.

Such policy resulted in a fast recovery of financial markets from the initial shock from late February to April 2020. At the time of completion of this book in late February 2021, the U.S. stock market index S&P 500 recorded an annual growth of 20% compared to February 2020, just before the pandemic had escalated. Technology sector index NASDAQ went up 46% in the same period due to the growth of profit and perspectives of American Big Tech companies which reaped profit from the lockdown. European markets recorded only modest recovery because European economy was hit harder by the pandemic than the U.S. economy; still, in late February 2021, Frankfurt stock index DAX was 6.5% higher than in February 2020.

The monetary policies of the central banks deserved credit for such an outcome. However, the recovery of economy in general was far from the recovery of the value of the financial assets of the holders of shares, bonds and other financial instruments in 2020, particularly in the European Union.

This is not the first time we are in the world of Greenspan put. Before the 2008 crisis, Greenspan's successor Ben Bernanke (governor of FED from 2006 to 2014) first tried to amend Greenspan put and cool down the overheated U.S.

market, where real estate prices had exploded. But it was too late. The subprime mortgage crisis erupted in 2008. Ben Bernanke is important for our story because, while he was still only a member of the FED Board of Governors, in November 2002, he made his historical speech, *Making Sure 'It' Doesn't Happen Here* (Bernanke, 2002). Worried by low interest rates, Bernanke resurrected in his speech the forgotten idea of helicopter money, thus moving it from scientific papers that almost nobody read to the economic policy mainstream.

Intellectually, the speech was revolutionary. It was also visionary, given the developments that were to follow, but it also started confusion about the use of the term “helicopter money”. Bernanke used Milton Friedman’s term in the context in which this term could not be adequately explained.

Bernanke said that the main problem of monetary future was not inflation but deflation – a general fall of prices resulting from inadequate overall demand. He warned that the hands of the central banks in the fight against deflation would be tied if interest rates were at their minimum. More specifically, if interest rates were at the so-called lower zero bound and if prices were still falling, real interest rates would be positive and would continue to burden company and household balance sheets and incomes, and the central bank would not be able to push the interest rates to the negative side. According to Bernanke 2002, there are two solutions for this situation:

The central bank can expand types of financial assets that it buys and accepts as collaterals, including securities of private issuers and long-term government bonds. It buys bonds as a means of control of bond prices at different maturities or the yield curve. This is important for keeping all interest rates low. This policy will later become known as a non-standard monetary policy of quantitative easing (QE). European Central Bank has been using this policy since the days of Mario Draghi (chair of the Executive Board of European Central Bank from 2011 to 2019). The still autonomous central banks from Europe’s periphery also joined in and are now using QE. During the pandemic, Croatian National Bank also used QE, before joining the European Exchange Rate Mechanism ERM II in July 2020.

The second message from Bernanke’s historical 2002 speech refers to the relation of fiscal and monetary policies. In times of crisis, the two should coordinate in order to lower taxes and increase budget deficit, but preventing at the same time any effect of such policy on the growth of interest rates. This is done by the abovementioned central bank interventions in the government bond



market. Bernanke (2002) said one important thing here: “Even if households decided not to increase consumption but instead re-balanced their portfolios by using their extra cash to acquire real and financial assets, the resulting increase in asset values would lower the cost of capital and improve the balance sheet positions of potential borrowers. A money-financed tax cut is essentially equivalent to Milton Friedman’s famous ‘helicopter drop’ of money.”

The importance of this statement cannot be overemphasized for three reasons. First, although he will try to amend Greenspan put as the FED governor in the pre-crisis period 2006-2007, Bernanke had always intellectually accepted the crucial role of the growth of value of financial assets for economic recovery. Second, this statement anticipates the outcome we had seen in markets in 2020: Central banks allow the bonds yields to drop and stock prices to grow, hoping to see positive overflow of effects from capital market to overall economy. Third, he reminded of Milton Friedman’s old metaphor of helicopter drop of money and connected it with the behavior of modern central banks.

This created major confusion because it blurred the essential (political) character of the “helicopter drop” mechanism. It is not the same if new money is issued in liberal democracy with all of its control mechanisms and with participation of thousands of decentralized actors who make autonomous decisions in financial markets and if it is issued and distributed in a totalitarian society arbitrarily, at the sovereign’s will. The difference in concentration of power which decides on money creation is crucial for our ability to tell good monetary cholesterol from the bad one.

#### THE ORIGINAL IDEA: REINTERPRETATION

Friedman’s helicopter money was first mentioned in his 1969 text *The Optimum Quantity of Money*, where he explained this theoretical model. To make an abstract theory more understandable to the reader, he used the following metaphor: “Let us suppose that one day a helicopter flies over this community and drops an additional \$1,000 in bills from the sky (...)” (Friedman, 1969: 4-5). Of course, Friedman did not think that such a thing could actually happen. He wanted to illustrate how an increase in money supply would result in proportional growth of prices, not production. He assumed that the total supply and demand in an economy were in a balance of full employment of

labor and capital, so new money could only cause inflation because there were no free production factors to be employed in order to increase supply as a response to increased demand fueled by new money.

For some unknown reason, Bernanke did not mention in his speech this important element of Friedman's idea, although he was not – unlike Friedman – talking about an economy that was in macroeconomic balance at the beginning. Bernanke assumed there was an initial imbalance – the supply exceeding the demand (the latter being “contracted” for some reason – for example, because of recession). In Bernanke's model, goods' prices drop (deflation) because of excess supply – unused capacities and unemployment. In this case, the task of the central bank's stabilization policy is to recover the demand in order to stop deflation.

In other words, Friedman's concept of helicopter money, intended as a metaphor for easier understanding of a theoretical model of an economy with full employment, cannot be used to illustrate a monetary policy in the conditions of unemployment. As no one reads half-a-century old texts, this mistake has stuck. This is why, in discussions on helicopter money, supporters of “helicopter money” try to discredit its opponents ideologically by saying “how can you be against helicopter money when it was ‘your’ Friedman who proposed it”. However, QE in liberal democracies is not helicopter money. The problem arises with changes in the constellation of political power which lies behind monetary policy decisions.

Thus, the non-standard monetary policy (QE) does not produce helicopter money if it is pursued in a system where political power is decentralized, where there are democratic control mechanisms and there are thousands of independent agents who make autonomous decisions to participate in transferring the new money to its end users (with many of these independent actors competing in the open market). It is much more likely that, in such a system, monetary expansion will be like good cholesterol if there is recession. Monetary expansion may not be benign even then, but the liberal-democratic and market frameworks significantly increase the chances of spotting and correcting the mistakes that could otherwise lead to high inflation and significant redistribution. After all, Ben Bernanke led the Federal Reserve through a period of non-standard monetary policy in which the institutional framework for monetary policy had not been changed and no major redistribution took place during his term in office.

The expansion of the collaterals accepted by FED in its monetary operations began as early as in 2008, when mortgage bonds were accepted. Due to panic and lack of information at the beginning of the Great Recession, their price was underestimated. But, Bernanke didn't stop at mortgage bonds. He knew he had to intervene aggressively with definitive purchase of long-term government bonds (quantitative easing, QE). In the three QE cycles, from November 2008 to late 2014, FED accumulated USD 4.5 trillion worth various financial assets, an equivalent of 25% of the U.S. GDP that year. FED Governor Jerome Powell did not hesitate to activate such a program in spring 2020, when it became clear that the pandemic would have dramatic effects on the American economy.

Studies have shown that the QE cycles that followed after the Great Recession of 2008 did not have particular effects on the economy. Indeed, some economist believe that long-term effects on social welfare could be negative even without triggering high inflation (Cui and Sterk, 2019). This is usually attributed to excess growth of prices of financial assets. The massive QE did not result in inflation of the prices of goods and services in product markets, but the prices of all sorts of securities (stocks, bonds) experienced the longest cycle of growth in history (2009-2020) before the corona crisis. Today, a year after its outbreak, we know that the corona crisis was but a pothole; after the initial shock, the prices of financial assets continued to grow even during the crisis. This is why many people object that the wealthier segment of the population – those who invest their savings in financial markets – fared better because the value of their savings had increased. Critics believe that this deepens the inequality gap and that inequality, in turn, negatively affects development.

Despite all this, there are no major disagreements among economists as regards the importance and strength of the initial QE. A timely and strong monetary intervention stabilized the markets even in the next to the last crisis (European Central Bank was late then). As for this last crisis, caused by the coronavirus, this principle was confirmed. Consequently, the initial QE undoubtedly was good cholesterol. It is far from any helicopter money. However, as time passes and prices of financial assets soar, the fear of inflation, redistribution and deepening of the inequality gap is growing. This is why today, a year after the outset of the pandemic, more and more people wonder if central banks may be exaggerating and if there is inflation looming behind the corner.

But this is still not helicopter money. Institutional organization of issuing of money has not been changed. And how could it be changed in a way that would change the constellation of power in society? Remember that we are primarily interested in the political structure of power on which money creation rests. At the outset of the pandemic, when panic exploded, many proposed a complete change of money creation mechanisms – abandoning the principle of dispersion of power and market agency and switching to direct distribution of (new) money by the government.

Imagine a year-long lockdown (some did at the time): you stay at home and do not go to work, but your paycheck arrives every month. Where does that money come from if economic activity and tax revenues have been reduced to minimum on the account of the lockdown? This is where the story about helicopter money begins: the government will issue the money (or will directly borrow it from the central bank) and the employees of the ministry of finance will forward it to your bank accounts. There is no control over the government (you passively stay at home) and long-term consequences of such a system are not being discussed. History is full of such helicopter money stories – even before the invention of helicopter – when new money was created without new debt. This is why the best way to understand helicopter money is to remind the reader of a political system in which power is concentrated in a single person.

#### ALEXANDER'S MONEY AND THE BABYLON INFLATION

Alexander of Macedon had control over Greek silver mines where his drachmas and tetradrachms were coined (McIntyre, 2020). This money was used by him to finance his military campaigns in the Mediterranean and Middle East, including the biggest campaign of them all – the one against powerful Persia. He used the silver and gold he had looted along the way (transporting money from the mines in northern Greece was then unreliable and expensive). Sometimes he built official mints. The biggest one was in Babylon.

Alexander's military power was such that he could establish a homogeneous monetary space with own currency. Money was practically falling from the sky, as from a helicopter: the exhausted, wounded and meritorious veterans settled in conquered regions. As they received money for their services, they monetized the backward local economies by spending their retirement money

locally. No one had to incur debt so that money could be created and begin to circulate. In fact, Alexander was paying his debt to his soldiers with new money, the minting of which he controlled. Still, there was some moral social energy that created the debt underpinning that money. On the material level, however, it was enough to have a military machinery capable of conquering territories and enough control over the mines, minting and distribution of precious-metal coins.

Based on what we know today, there was no inflation; the monetized space expanded with approximately the same speed as minting of coins. It is possible that Alexander or one of his advisors understood the monetary technology and managed it, because not all of the looted gold and silver was melted into coins. By retaining certain reserves, the quantity of coins in circulation was regulated.

Of the large supplies of precious metals, the largest was the one that Alexander brought back from his 324 BC Persian campaign. However, soon after that he died (in 323 BC). According to Peter Temin from the MIT, who researched this episode, a large portion of the reserves of precious metals was activated for monetary purposes during the struggle for Alexander's political and financial legacy. Just like Friedman's helicopter money predictions, the first ever recorded major growth of prices ensued – the Great Babylon Inflation (Temin, 2002).

If you think that historical anecdotes like this one have no place in a book describing the reality of the 2020s, you couldn't be more wrong. Even today, a deep change of constellation of political power can create alternative monetary and institutional systems that, while technologically different from Alexander's (we have bank accounts, credit cards, ATM machines, POS devices and cell-phone financial apps), would essentially resemble his systems. It is easy to image a sovereign (a powerful dictator or government) who arbitrarily decides on the following:

The system for granting credit cannot be decentralized; instead, it will be placed under the control of the same authority which controls the money supply;

The sovereign collects taxes which are payable only in the sovereign's currency (this is a main tenet of the so-called Modern – and yet, ancient – Monetary Theory, MMT);

The second main tenet of MMT is that money is distributed only via government expenditures (it is created in such way that the state spends more than it

collects by taxation) and, as the sovereign controls everything, he can prohibit import of goods or export of money abroad.

If the sovereign maintains close control of the money supply and if he does not issue it in excess quantities, from this blurry theory emerges a seemingly feasible idea that a society can “enjoy” fruits of this monetary model, isolated in its self-sufficiency as in some fairytale. At that, it does not matter if there is a central bank or not. The law regulating its operations, the building, the people – all this can function as a façade that hides the real constellation of power which ensures obedience of the central bank “governors” who act on the orders of the authority in which all power is concentrated. No so long ago, the totalitarian regimes of the 20<sup>th</sup> century functioned the same way. In Croatia, such mechanism that generated high inflation was changed only in 1993.

The moral of this is that money creation mechanism should be perceived through political framework. Primarily, how power is structured around money – is it concentrated, like in Alexander’s case, or is it dispersed, like in modern democracies in which market (thousands of people who make autonomous decisions) serves as agent in the process of money creation. In the light of this, modern democracies have learned to control inflation by preventing excess concentration of political power that could abuse the money supply monopoly and cause inflation. The non-standard measures of monetary policy (QE) are still within the range of democratically controlled solutions the application of which is brokered by decentralized actors in numerous financial markets. This is the fundamental reason why it did not lead to high inflation.

Nevertheless, the question arises – when can QE be considered exaggerated? When does good cholesterol threaten to turn into bad one and when does the well-known saying that road to hell is paved with good intentions come into effect?

## QE IN TIMES OF THE PANDEMIC

If money creation mechanisms are to be evaluated on the basis of what we have learned by now, we must analyze how the real power is structured in the quadrant government – central bank – parliament – financial markets. In Western democracies, these four segments are separated. Market participants are numerous and they make their decisions autonomously. The central bank exerts its in-

fluence on interest rates by means of its quantitative easing policy and forward guidance. The central bank's influence remains strong in this model, but the fundamental tenets about four separate segments remain intact nevertheless. A certain level of fiscal-monetary coordination – mutual exchange of information and opinions between the central bank and government – is not excluded in this system; on the contrary, it is welcome for technical reasons, in order to avoid uncoordinated actions that could erode trust. But everything takes place within strictly separate authorities and in line with autonomy of decisions.

In Euro area, the multidirectional permanent pressure of democratic public and levers of authority joins European regulations as additional control. First, through European Parliament to which ECB reports. Second, through free media, where monetary policy is bitterly discussed. Third, through national media, which influence local politicians who, in turn, convey messages and actions to European institutions. Fourth, through national courts: let us remember the dramatic questioning of ECB's monetary policy instruments before German Constitutional Court. Fifth, through European courts. Although it is often wrongly claimed that ECB is a poorly controlled institution in a formal way, there are actually five mechanisms of its democratic control. This is why many people in Europe believe that ECB's hands are too tied because ECB is the only central bank in the developed world that does not have its single state. In fact, the delicate balance of European political relationships manifests itself the most clearly in ECB. This can result in a somewhat slower reaction or in some milder consideration, but it also means that ECB must seek balance at the always stormy sea of the decentralized political power in the European Union.

The pendulum thus swings and always returns to its center of gravity. If the monetary policy is too passive, pressure begins out of fear of deepening of economic differences between the countries of Euro area, which include the perpetual tensions between North and South. If the monetary policy is too expansive, objections begin out of fear of inflation and disguised monetary redistribution which, in turn, threaten to arouse monetary nationalism – something no one in ECB and its Governing Council can ignore. In the times of the pandemic, this delicate balance reflected an intensive use of a whole range of strong monetary instruments: from EUR 1.85 trillion-worth Pandemic emergency purchase programme (PEPP) to practically unlimited Targeted Longer-term Refinancing Operations (TLTRO) program for credit support to the private sector. ECB responded in a way appropriate for the intensity of the social



and economic shock of 2020. In the years to come, the delicate balance will help find answers to the questions of how and when reduce monetary intervention to avoid high inflation and redistribution while enabling recovery from the recession caused by COVID-19.

Things are different with the nation-states which still have their central banks, particularly if they are not-yet-fully-evolved democracies. There are less lines of force leading to delicate balance and more people making key decisions behind the closed doors. Let us take a look at how does Croatian model of QE fits in this picture.

Croatian banks are mostly integrated in European banking groups whose risk managers estimated in March 2020 that Croatia's GDP would drop significantly and that its deficit and public debt would grow. They estimated the growth of risk and possibly the drop of credit rating. Their job is to protect their banks from risks because that is where savings are. This is why, from the beginning, banks were ruled out as potential creditors of the state budget, the expected deficit of which soared together with the need for financing (to 7.4% of GDP in 2020). After banks had been ruled out as potential budget deficit financiers, the range of potential creditors was narrowed down to other foreign buyers of government bonds, domestic buyers (primarily pension funds and, to a lesser extent, insurance companies), and the indirect support models offered by the central bank.

The Eurobond market reacted instantly at the outset of the crisis and the prices of bonds dropped (when the prices of bonds drop, the yields at which the government can borrow money grow). In March 2020, the 10-year yield on Croatian government bonds was approx. 2%, when identical German bond yielded (or taking away) -0.6%. This difference of 2.6, called "spread" by economists, grows in crises because investors move their money to so-called safe havens such as German government bonds. There was fear that the yield would keep growing if Croatian government issued bonds worth dozens of billions of kuna and introduced them to the market in order to finance its growing deficit after lockdown had been introduced. This is why ministry of finance temporarily gave up Eurobonds and turned to domestic market. Minister of finance wondered if there were actors there willing to finance the state under more favorable conditions for the government than those in the Eurobond market.

But domestic market was "frozen" when the pandemic broke out. Its protagonists – banks – had lost appetite for government bonds when they assessed



the risk. This is when Croatian National Bank (HNB) stepped in. Instead of reviving the interest for government bonds in domestic market with frequent and carefully designed auctions, boosting the market with multiple actors (who, let us not forget, make their own autonomous decisions), and thus indirectly paving the way for the ministry of finance to issue new bonds, HNB ventured into direct purchase of bonds via occasional but rich auctions coordinated with the ministry of finance.

The EU regulations ban HNB from direct credit financing of the state budget. This would jeopardize Croatia's admission to European Exchange Rate Mechanism that was nervously expected in spring 2020 (and it actually happened in July that year). Market participants therefore had to be found who would serve as a "bridge" between HNB and the ministry of finance and who would be reliable enough to carry out transactions at the agreed price, more favorable than the one in the international market. Pension funds are an ideal partner for such a strategy. Government bonds account for approx. 70% of the assets of pension funds - the most important players in the government bond market. The assets they manage for future pensioners account for some 30% of GDP.

Pension fund managers are employees of banking groups – pension fund management companies belong to them. However, pension system has its special regulations. This means that the state always holds the Sword of Damocles above the heads of pension fund managers. The government can change the regulations by which they operate (e.g. HANFA, the non-bank financial regulator, fixes the management fees of which fund managers live). This is why fund managers are always more oriented to public sector than bank employees (the latter ones mostly have contact with private companies and citizens in their everyday work while government is the biggest individual client of pension managers who invest mostly in government bonds). Besides being the most important buyers of government bonds, pension funds always encounter the state when investing in shares, because the state is an important co-owner in the companies in which pension funds also have shares.

So what did Croatian QE, co-directed by ministry of finance, central bank and pension fund managers, look like? First, on 28 April 2020, pension funds sold to HNB the old government bonds from their portfolios. Then, on 4 May, they used the proceeds from it to buy Croatian government bonds with foreign currency clause in an equivalent amount EUR 1.445 billion. Besides having been agreed in advance, this transaction was carried out at non-market prices

(higher prices and lower yields than in Eurobond market). The exact weighted average of the price at which the bonds were sold to HNB in the first round has not been published but we know that, in the second round (purchase of the ministry's new bonds), the seven-year bond with a return of 0.75% was purchased. At the same time, Croatian seven-year Eurobond yielded 2%. The difference between the two was 1.25 percentage points.

Future pensioners suffered no damage with this transaction because the old bonds were sold to HNB at a high price and then the new ones were purchased from the ministry of finance, also at a high price. The fund managers only served as a bridge between the central bank and ministry of finance, which are located less than one kilometer from each other in downtown Zagreb. This is how HNB subsidized the government via pension funds, while wisely making sure that no damage is imposed on investors in pension funds.

Although the panic that occurred at the outset of the pandemic made most of the observers to tolerate these transactions as benign, there are three major problems with this way of creating money. First, the nominally independent HNB and pension fund managers were there for the government as a source of fresh money in case of necessity. This substantially reduced the budget limits and the incentives for changing the amount and structure of state budget. Second, the domestic government bond market *de facto* wasn't there at that moment; it had disappeared at the outset of the pandemic. HNB had an opportunity to boost the domestic market with transparent auctions, as other central banks do. It would kill two birds with one stone – indirectly facilitate financing of the government and directly help the development of the domestic bond market. But the opportunity was missed. Third, on 30 April, the government submitted to the parliament the amended Mandatory Pension Funds Bill enabling the funds to hold deposits at HNB and ECB and borrow money up to 5% of the value of their net-assets or 15% in contingencies. This way, pension funds are turned into so-called shadow banks that directly participate in the money creation mechanism.

From the money-issuing perspective, it does not matter because the banks mostly have deposits in liabilities and credits in assets, while pension funds have future pensioners' accounts in liabilities and securities in assets. But these technical details cannot change the important fact that both banks and pension funds now directly participate in the monetary transmission mechanism. This is not helicopter money yet, but it is a certain departure from the tradi-

tional model of independent actors towards the model which is similar to the helicopter money model.

Still there is strong counterbalance that could prevent financial relations from sliding off to the politically negotiated helicopter model instead of to the market model. It is the strong intention of both Croatian government and HNB to introduce the euro. The probable admission to the Euro area, a year sooner or later, will make Croatia part of that delicate European balance of powers discussed earlier. True, it has its own problems, but the five different controlling lines of force described in this chapter (European Parliament, national politics, media, national courts, European courts) are a guarantee that ECB will not turn into an issuer of helicopter money which some modern-age Alexander will be throwing onto his subjects.

## DISINTEGRATION OF THE EUROPEAN UNION, “FINALLY”

When the pandemic broke out, media started spreading the thesis that the European Union could not survive the shock. This is our second horseman of the apocalypse: the idea that the EU is “discredited”, that it “failed again” and that the corona-crisis shock would finally cause its “disintegration”.

There were a few origins of this idea. Some epidemiologists were desperate because not all member states reacted in the same way and at the same time, so the public-health measures were mostly introduced nationally. We heard similar words from politicians and economists who urged for resolute and coordinated fiscal responses in order to mitigate the economic consequences of the lockdown; if not, they claimed, the EU would collapse in a bitter economic crisis. The causes of the grim prophecies of immediate end of the Union were different, but their common denominator were two deep reasons. Ominous prophecies link two views of political relations on the European continent, both being traditional sources of frustration and disappointment: the first one is Eurofederalist and the second one is sovereignist. Both contain the seed of abandoning the European idea.

The Eurofederalist utopia was embedded in the European Union’s foundations after World War II. Over time, it spread to a large portion of Europe’s elites that perceived Eurofederalism as a response to the devastating force of European nationalisms. The idea of European solidarity was also attached to it. However, it turned out that the European solidarity myth was not realistic, at least not in the way that Eurofederalists imagined it. This caused resignation among the Eurofederalists. The predominantly national solutions and differences between countries in the fight against COVID-19 only deepened that resignation.

The European solidarity myth usually comes down to the idea that tax payers from the more developed North should pay unemployment allowances and health-care system costs of the South, on top of the amounts which are already being poured to the European Union’s common budget (approx. 1% of the total GDP). As this turned out not to be possible (for the voters in the North do

not support such a solution), the federalist type of resignation comes down to a simple political cry that could also be heard in Croatia at the outset of the pandemic: “If there is no solidarity and togetherness, then such a European Union should not even exist!” On the other hand, the epidemiologists who despaired over the absence of common and simultaneous European reaction to the pandemic perhaps did not think about Europe’s political foundations very much but rather observed the problem from the technical-medical point of view.

In the text below we will show that European national diversity can still turn out to be an advantage if it serves as a platform for offering various ways of intervening in uncertain conditions. Europe is not – nor should it ever become – unitary in terms of imposing solutions from a single center, as if it were an empire or a centralized state, unless such a solution (the best one) stands out in competition of various attempts on the national level and then, by means of imitation and coordination, is filtered as a solid, proven standard. The principle of diversity and competition, as a copy of the ordoliberal principles of a sort applied to the political functioning of the Union, can serve as a possible plan for Europe’s future functioning. We hope that this pandemic will make this plan more visible. This plan respects the sovereignty of nations and sovereignism as a feeling and political program, but discards the sovereignism that arises from the indiscriminating national romanticism and turns into a narrow-minded nationalism.

The pandemic has also shown that the world is so connected and networked that a sovereignist autarchy could lead into even bigger problems than Eurofederalism. This is why, between the sovereignist and Eurofederalist disappointment with the Union, liberal delicate balance imposes itself as a sustainable possibility.

Modern sovereignism, as the second pole from which the thesis about a “discredited EU” originates, is perceived as belonging to the political Right, although sovereignism in terms of rejecting the EU as a relevant civilizational and political framework is not so rare on the far Left either. This is because extreme supporters of national or some other collectivistic romanticism reject any idea of an international compromise.

Skepticism towards the European Union is embedded in the viewpoints of AfD in Germany, of Le Pen in France and of Orbán or Kaczynski in the Eastern EU, to mention just the most important ones. Their political attitudes suit the countries which, for some reason, do not support the strengthening of the

EU (Russia, China, former president Trump's America). These countries have foreign policies oriented towards bilateral alliances (e.g. Putin's Russia – Orbán's Hungary, China – Italy, Poland – United States in Trump's era) and their propaganda (e.g. Sputnik portal, sponsored by the Kremlin) has been trying to stir up skepticism against Europe (EEAS, 2020). In this context, the drama caused by the outbreak of the infection at first served as a megaphone for those who claimed that the EU had been discredited. The pictures exchanged via social networks added to it – like the photo of an Italian lowering the Union flag and hoisting Chinese, or the photos showing Chinese donations of medical equipment (which flooded the news and social networks at one moment, although the mutual assistance of EU member states exceeded many times over, by quantity and quality, the donations from outside the EU).

Sovereignism, which has an asymptotic tendency to autarchy, should not be perceived as an imported product, although it is influenced by ideas coming from the East. It naturally arises from the worldview rooted in part of the population. Emanating from national romanticism, sovereignism has its intrinsic democratic legitimacy that should be allowed for before it grows into an ideology of autarchy. It is, therefore, important to keep in mind that Euroskepticism does not arise only from the naïve national romanticism which sometimes has Nazi or Fascist overtones. This type of romanticism-sovereignism can also emerge as a reaction to excessive imposing of centralistic solutions and because of objective weaknesses of the existing center. Many weaknesses of Brussels, primarily its tendency to exaggerate in regulating all aspects of living (imposed by democratically poorly controlled central bureaucratic and political elites) is perceived as a threat that provokes strong criticism and reactions, sometimes justified. The absurd decree that cell-phone chargers must be identical and other such standards is but a benign indication of a deeper problem. Brexit was also partly provoked by latent British fear of an ever-strengthening politically distant “center”; it is not only a result of the deep English nationalism and the domestic problems and political struggles right-of-center in Great Britain.

The fear of a distant political center is nothing new. Since the first days after the fall of the Berlin Wall, many politicians and intellectuals in Eastern Europe were skeptical about such a center. Croatia's first president Franjo Tuđman knew that the EU was Croatia's only possible orientation, but he was a romantic nationalist. Václav Klaus, the reformer and first prime minister of the independent Czech Republic (1993-1998) and later its president (2003-2013), was

both nationalist and Euroskeptic (but of liberal origins, unlike Tuđman). After all, Klaus is a member of the mythical Mont-Pèlerin Society, founded by Hayek, Popper, Knight, Stigler and Friedman. Tuđman – a former communist – was far from that society.

Skepticism towards the excessive power of the center is not only a hindrance on the way to the “ever closer union”, but also a welcome balancing factor that guards the foundations of liberalism and democracy the origins of which are on the national level in Europe.

In the text below we will first analyze the important components of radical Euroskeptical views and observe how the corona crisis boosted their appeal. Later on, we will try to remove the ideological veil in order to take a better look at what Europe really is and what it actually does in this crisis. Today, a year after the outset of the pandemic and in the year in which a new program, Next Generation EU, will be launched, proving that the Union has managed to rally strength and react to the corona crisis may seem like a waste of time. Nevertheless, the Union is always on an exposed position, so it doesn't hurt to summarize the events of the turbulent 2020.

#### EASTERN PERCEPTION: EUROPEAN UNION AS AN ALLEGED CRADLE OF MODERN-DAY COLONIALISM

In a text that describes Euroskepticist views, Tado Jurić from Croatian Catholic University summarizes five key theses with particularly strong points of reference in Southern and Southeastern Europe (Jurić, 2020):

European Union took “our” enterprises (industry).

The profit of “our” enterprises is being sucked out by the Western countries of the Union; what we receive from the EU funds and similar transfers is not even remotely close to the amounts leaving to the North and West of the Union.

They are now sucking out “our people”, too (Croatia faced a sweeping wave of emigration between 2014 and 2020) and no one in the Union will pay even small compensation for this, so that we could continue to develop.

The Protestant Europe has been colonizing the Orthodox and Catholic Europe, thus creating preconditions for the next phase of “population exchange”: Catholics and Protestants in the South will be replaced by a new pool of African labor force which is to settle in Europe's peripheral areas after they have been vacated (a thesis by Croatian demographer Šterc), because:

European Union is primarily a union of capital and profit, with powerful Germany at its center.

Clearly, this set of ideas addresses the economic aspects of the Union's functioning and presents them in a negative way. However, its insurmountable problem is the easily verifiable fact that the very states of New Europe underwent a period of one of the fastest economic and social growths in their history after the Berlin Wall had fallen and, particularly, after joining the Union. When commenting in the book *Prešučeni trijumf liberalizma* (Šonje and Polšek, 2019) marking the thirtieth anniversary of the fall of the Berlin Wall, the authors drew a conclusion that the countries that had carried out timely, swift and deep liberal reforms and institutional reforms in the past three decades were more successful, which also means that they managed to prevent emigration or reduce it substantially (Slovenia, Slovakia, Czech Republic, Estonia at a later stage). The less successful countries, including Croatia, failed to do it. This is not the Union's problem, but a problem of the peoples and political elites in these countries.

In the conclusion of his criticism of the EU, Jurić urges for: (1) introduction of a one-half reciprocity (e.g. for every two nurses that move to Germany, they send one to us); (2) joint health and pension insurance on the EU level; and (3) transfers for education (because some of the people whose education in Croatia was paid by Croatian tax payers will go to Germany or Ireland). None of these propositions can be qualified as based on ideology or irrational. All of them have certain points of reference in the experiences of less developed EU members such as Bulgaria or Romania, which also have numerous emigrants in Germany and other developed member states. Lithuania and Latvia also experienced similar migration cycles as Greece, Portugal and Spain before them.

Clearly, starting from the radical tenets of romantic economic nationalism with a Weberian admixture of religious relationships, Jurić is actually looking for a recipe for a sustainable future of a Union in which even the weakest will have a chance to develop. Based on his wrong view of economy, Jurić believes that development can be boosted with international transfers. He does not mention critical intrinsic limitations for development that can make transfers as useful as pouring water into a bucket with a hole at the bottom.

These domestic weaknesses that Jurić fails to mention in his text (although, truth be told, he addressed them publicly a number of times) and that, due to that hole at the bottom of the bucket, would limit the development even if



the transfers were a few times higher, refer to institutions. They are generally weak in less developed member states and do not inspire citizens' confidence because they operate in a distorted manner and to the benefit of narrower circles of the elites and their buddies. Weak institutions mean corruption, poor education, inadequate knowledge, entrepreneurial courage and social respect for entrepreneurs, excess taxes and other levies etc. Therefore, migrations also take place because of a domestic push (intrinsic weakness) and the appeal of a destination (income, career and quality of life that can be achieved in the developed countries like Germany, Austria and Ireland). This amalgam of push-pull influences is hard to disentangle and it is hard to tell which component is more relevant. The sovereignists in the eastern EU countries generally underestimate the push (intrinsic weaknesses) and tend to seek compensation from the receiving countries as if pull factors are critical, thus creating a paradox: their position does not imply weakening of the Union. On the contrary, it implies its strengthening through more transfers.

If crying over lack of European solidarity is universal both politically and as an idea in a sense that both the leftists and rightists use the same cry, intensified many times over ("There is no solidarity in Europe!"), then it is no surprise that we live in a large paradox so aptly described by Michael Mayer-Resende (2020) in *EU Observer*. In a short text with a great title, *The Price of a European Order*, author explains the European paradox that has crystalized even through the corona crisis. Ines Sabalić, an acclaimed Croatian journalist and expert for European relations, also noticed this paradox in one of her Facebook comments: *abolishing trade, closing borders, squabbling between countries – isn't corona crisis a wet dream of every radical rightist and nationalist? If so, why are they in the front ranks of those who demand more from the EU?*

Analyzing this paradox, Mayer-Resende concludes matter-of-factly that rich member states should indeed give more because they themselves will have problems recovering from the coronavirus soon if large portions of EU's south and east fall back. He warns, however, that there can be no rights without obligations; the two must always be in balance. The nations who hope to "piggy-back" on EU transfers on their way to development while undermining the values of European liberal democracy at the same time should feel free to miss the next round of distribution from the common funds and choose their own way, he concludes.

Mayer-Resende was clearly under impression of the bitter conflict between the old EU members on the one hand and Poland and Hungary on the other. That conflict marked the pandemic year of 2020. The old members tried to link access to EU funds (Next Generation EU in particular) to adhering to the rule of law, which Poland and Hungary interpreted as a threat. Their conservative right-wing governments had often been criticized in the West for suppressing the freedom of media and undermining independent judiciary. Polish and Hungarian governments were right when they became alarmed that a strict application of the rule of law could turn off the tap of European money for Warsaw and Budapest. A compromise was reached in December 2020, thus removing political barriers from access to Next Generation EU program and enabling the passing of the seven-year financial framework (the EU budget) worth as much as EUR 1.074 billion.

The compromise with Poland and Hungary left open the matter of the principles on which the modern European Union rests. It is still hard to establish where exactly is the line of compromises between liberal democracies and authoritarian regimes inside EU and how to recognize the turning point after which a nominally democratic regime has become so autocratic that it cannot be considered a democracy anymore. This question arises on the global level (the relations with China, to which the entire second part of this book is dedicated), in America (Trump's conservative revolution – the alleged attack on the “establishment”), in Europe (the relations with Russia, Ukraine, Belarus and Georgia as its hot spots), and within the EU (the relations between the old and the new members, particularly with Hungary and Poland in the era of Orbán and PiS).

The threats to freedom linked with the reactions to the coronavirus would not cause such an anxiety if it appeared in a period of democratic optimism. But the pandemic took place in the period in which stores are full of books predicting the end of liberalism and democracy and in which elections are easier to win with speeches about the end of the world as we know it. Also, the pandemic took place in the times when the Eurofederalist dreams of an “ever closer union” were definitely left to history textbooks and when Europe is permeated with existential anxiety. This is why, during the initial shock in spring 2020, many observers felt they were losing their grip. And yet, a year after the initial shock, things look differently. The EU has turned out to be more resilient than it seemed. So what is this EU if it is neither a federation nor a confederation, but a unique political entity? How did it manage to survive the

pandemic and at the same time take measures that in “normal” times it would certainly not be able to take?

#### WHAT IS THE EUROPEAN UNION?

The streets of many cities in the world were full of scare-mongering weirdos spreading fear of imminent cataclysm and explaining to the people in the street that the secret global government had produced the virus in its labs in order to enslave mankind or implant electronic tracking devices in people’s bodies. Part of this “normally” deranged psychological reaction moved to mainstream media. During the election year of 2020, most discussions on immediate disintegration of the United States, with daily clickbait headlines in mainstream media, were characterized by total ignorance of America’s history and political system and its huge capacity for adaptation through open social conflicts. Using the same pattern, the discussions on a totally discredited European Union were mostly characterized by failing to understand the European history and how the Union’s monetary system was established and functioning.

So, what is the European Union? What helped the Union make it through the pandemic stress?

Europe is a relatively small, densely populated, closely connected and politically atomized area with permanent need for political compromises. The purpose of compromises is to suppress a strong urge for leaving the joint institutional arrangements. The principle of compromises is the true foundation of the EU and is reflected in the functioning of its most important institutions – Council, Parliament, Commission, Court and the monetary union. This principle also explains why making joint EU decisions takes so long, which is particularly annoying in the conditions of sudden and strong crises, when everybody expects quick decisions, as was the case in March 2020. Such conditions trigger a natural impulse in people who watch evening news and see politicians in suits spending long hours at fruitless meetings: “Oh, forget it! No use of them! It’s every country for itself!” was the mantra of the day in many homes all across the European Union. When a compromise is reached after all, there is an impression that everyone has lost, because the common denominator is always smaller than the maximalist demands with which some governments begin negotiations. For example, when the EU spring 2020 package of assis-

tance to the member states was being negotiated, Italian prime minister Conte threatened that Italy would find “its own way” if there would be no common “corona bond” (an EU bond for which the tax payers of the fiscally disciplined countries of the North would de facto guarantee). Eventually, neither were the bonds issued nor did Italy seek its own way. Of course, Italy took everything that was put on the common European table because no financier outside the EU could even remotely compete with the benefits of common institutions that the member states enjoy. Individuals may hoist Chinese flags or glorify Putin, but we still remember how fast Greek prime minister Alexis Tsipras returned from his 2015 trip to Moscow, where he went to find out if Russia could possibly offer a more favorable financial agreement to Greece than the one offered by the Eurogroup. Conte knew very well how many Italians had been treated in German – not Russian or Chinese – hospitals at the peak of the first wave of the corona crisis in Lombardy, but he also knew how to negotiate and, at the same time, how to send the messages that part of the Italian public wanted to hear.

In the end of the day, a compromise is always reached in the EU. However, nobody cares about how better the new European situation is than the original situation; instead, everybody cares about how worse the new situation is than the one hoped for at the beginning of the negotiations and communicated to domestic public at the time. This is why the EU is always perceived as a problem and not as a solution.

Obviously, anti-crisis measures are agreed on the national level much faster than on the European level. The fact that the EU is relatively slow compared to the national governments comes in handy to the governments as a point of reference for highlighting their own capabilities, speed and results. In his public appearances in the week of 8 April 2020, Croatian finance minister Zdravko Marić kept comparing the slowness of the EU and swiftness of Croatian government in introducing anti-recession measures. Such a fig-leaf presentation, with the use of the EU as a “shield” towards the public, is part of the folklore in many European countries. This leads to failure to present in a rational way the results and instruments of the European Union, but it is also a practical tool that national political elites can use for shaping the opinion of their voters. As a result, the public stays uninformed and, in many cases, misinformed.

The paramount damage here is the fact that the public remains deprived of the opportunity to understand the most important values of the EU today. Its delicate internal balance equally takes into account compromise and compe-

tition, allowing for varied national policies and interventions on the one hand and a strong framework for cooperation in which a minimum of harmonization and common solutions is achieved through compromise on the other. The paradox lies in the fact that this virtue is sometimes, if not often, perceived as a shortcoming. But as a matter of fact, the national diversity in the EU is a source of competition for various policies and instruments, which increases the odds that the best solutions will be found (and the worst ones eliminated).

For example, the initial panic about the outbreak instigated a wave of criticism of Sweden because this country had insisted from the day one that it would not introduce the radical lockdown used by most of the member states in March and April 2020. A similar campaign took place in Croatia during the second wave in autumn of the same year, when Croatian government decided it would apply the Swedish approach. Eventually, neither Sweden nor Croatia ended up among the countries worst hit by the pandemic. However, that fact did not silence the critics for whom avoiding a radical lockdown was merely Fascism and sacrificing the lives of the elderly, so that the young and privileged could go on with relatively normal lives.

Diverse and competing types of intervention, not only in epidemiology but also in pursuing policies in general, filtering the best solutions and learning from experience, adopting the best practice as part of firm cooperation based on compromise – this is the European principle that manifested its sustainability even during the pandemic. Yearning for other solutions – firm, swift and imposed from a single center – even under the auspices of Her Majesty Science – irresistibly reminds of the structure of fragile European empires that eventually met their doom, as we know from history, especially in this part of Europe.

When we criticize the science-based solutions imposed from above, our intention is not to diminish the important role of science in creation of policies – far from it; we just want to remind of the experimental, empirical nature of science which is manifested most when facing the unknown. Technocratic scientism that has no problem presenting a hypothesis or a wild guess as a done deal – the best and verified solution – is no science but a negation of it. This is why it is good that there is no single center of power in Europe that could impose a one-sided experiment on almost half a billion people.

It is not debatable anymore that governments had to intervene in social life with resolution in order to mitigate the consequences of the initial spread of the virus and prevent the collapse of the health-care system. No one in their right

mind thinks anymore that the solution for the pandemic was to let the virus spread freely so that collective immunity could be acquired. However, the fact is that restrictions of various degrees with very different health outcomes in European liberal democracies showed that human society is not a machine composed of virus carriers. Measures can be adjusted gradually, based on (rather slow) development of scientific insight, while keeping in mind that, like always in medicine, every intervention measure has both direct and visible effects and less direct and less visible effects manifesting themselves in the long run (recall Table 1). This is why the European Union must remain as it is and resist all attempts of controlling it from a single center and thus turning it into a modern-age empire like China or Russia, ruled by a “wise ruler” and his science counsellors.

This is why the myth of a Union without solidarity – a “Union of capital and profit” – that has spontaneously attracted people from both extreme Left and extreme Right, is just a myth – one of the biggest myths of our time. Uttered so many times and, during the pandemic, reincarnated in the form of a sneaky thesis that people were being sacrificed to capital and profit wherever a radical lockdown had not been introduced, this thesis has become universally accepted in some circles. But the Union did not discredit itself during the pandemic. It proved itself as a framework for different national policies and it showed it could mobilize significant funds for pursuing the solidarity policy: the amounts being redistributed through various institutions of the European Union are very high, by far the highest in history. If we add to this the measures of European Central Bank, Next Generation EU Program and the measures from the April 2020 package, the Union’s intervention reaches the historical proportions of approx. 20% of GDP.

At the time of completion of this book, there is a massive ongoing vaccination campaign. The above described pattern of tensions can be seen in it: reactions ranging from enthusiasm due to development and joint acquisition of large quantities of the vaccine to disappointment caused by the problems in its production and distribution. And yet, competition and cooperation in the EU keep on marching side by side, in the European way, reconfirming the old principle that crises make Europe stronger. But the European crisis response model is not untouchable or unchangeable. It will last as long as the citizens understand it and support it.

## SELF-SUFFICIENCY

The lockdown that was introduced in March 2020 to prevent the spreading of the coronavirus showed that something hitherto deemed unimaginable was actually imaginable: the “end of globalization” was suddenly possible, as well as redefining of the relations in the triangle U.S. – China – EU (particularly between the first two); national borders were closed overnight; the stock markets collapsed for a while; the Union’s single market was threatened when Germany banned the export of medical face masks (although the problem was quickly solved); as for tourist trips and air travels, we could only dream about them. In such a situation, people needed something to hold on to.

It would be naïve to think that that the corona crisis did not shift that something. In a world of ideas and media, a new world was born for a short while, the world of “self-sufficiency” – our third horseman of the apocalypse. This world could be an opportunity, many believed. Tradition has it that the flatlands of Slavonia in Eastern Croatia between Serbia across the Danube and Hungary, a place that saw mass migration of young people to the West in past years as earlier in history, could always feed “half a Europe”. Some even started to imagine the brave new world: a smart government will help organize production chains in parts of the country where there are raw materials base. The first such production chain refers to food: “from farm to table” and “from sea to table”. The second one is energy (hydropower, wind, sun – Croatia has plenty of that). The third one is the “forest chain” (“from timber to furniture”). The fourth chain is our military industry – we have a robust industry of arms and military equipment, we can supply navies and armies of the world with ships and weapons and the knowledge accumulated in IT and communication sectors (which exceeded 5% of Croatia’s GDP last year) installed in them. The fifth chain refers to health care: we have good physicians and pharmaceutical industry. When we combine it with the IT and communication sectors, we will have one of the best health-care systems in the world and medicinal equipment will be produced locally. The sixth value chain includes public services – administration, education, police, judiciary... When all this is digitalized and integrated, its efficiency will be beyond belief. Futuristic e-weddings have been



announced, too. True, tourism, by which Croatia is widely known, will be gone for a couple of years – but this is good in the long run: we will not be a land of “servants” (cleaners, waiters, cooks) anymore. We will become a land of content and prosperous people working in agriculture, restored industry, IT... All the government has to do is organize this major transformation. This is how the dream looked like.

These ideas are not new and they are found elsewhere. The ideas of self-sufficiency have always been around. The coronavirus pandemic merely intensified their appeal by stopping briefly almost all international trade. In order to realize what is good and smart in this idea and what is bad and dangerous, we must go back to the roots of the concept of creation of value – the story about production of knowledge and the role of trade in economic development.

## SOURCES OF ECONOMIC VALUES

If you take a look around you and think about what is contained in every object that you see, you'll realize it is knowledge. The vase with a flower does not contain many layers of knowledge. The knowledge contained in it dates back to the early potters who appeared around 18,000 BC in what is today China. The vase is thus old knowledge, and so are tables, chairs, cupboards. Invented long ago, these objects have acquired their present-day shapes. In the age of industry, they were improved and are now being made in infinite variations of design and materials. The books on the shelf also have their history of production, ever since Gutenberg in the mid-15th century. Unlike them, a TV set contains new knowledge. The first experimental TV set, resembling the ones we know today, was invented in Paris in 1909. It was followed by a series of major innovations and improvements in production, transmission and reception of TV image. They were necessary steps on the way to the quality service of today.

The innovation and knowledge are stacked in products like growth rings in a tree, but we cannot separate them from the innovation and knowledge built in production processes. Some innovations and knowledge are visible and tangible, while some (important) innovations remain hidden. These are the ideas built in the services paving a product's road from the place of production to the consumer. Information services, Internet communication and sales, marketing, commerce, transport and logistics – all this is important for the pro-



ductivity of the entire chain from the producer to the consumer and the sales price depends on it.

At the first sight, there is no reason not to believe that such high-quality chains could be organized on the state level. However, the problem with the concept of national self-sufficiency begins when we realize that dissemination of innovation and knowledge requires an international exchange. Almost every complex product bought in the U.S. or China contains a relevant amount of knowledge originating from outside these countries. Generally, the smaller the population of a country, the bigger the probability that the content in the products and services used by the citizens come from abroad. All this particularly refers to the technologically complex products and services that have a very positive impact on the living standards.

Every society has three options for solving this problem:

Own production based on imitation, protected in domestic market.

Own production based on contracts.

Import.

#### OWN PRODUCTION BASED ON IMITATION, PROTECTED IN DOMESTIC MARKET

This strategy was tried in socialism and in capitalist societies in some stages as well. It worked to an extent for the products of lower technological complexity (because they could be imitated by economically underdeveloped societies – e.g. furniture, railroad tracks, roads and houses). In socialism, the more complex products and services (e.g. ships) had problems with quality and/or price. For this reason, they were subsidized. The resources of the more productive parts of the economy were being spent on these subsidies, thus slowing down the economic growth in the long run. With the most complex (and most idea-intensive) products such as automobiles – like Trabant and Wartburg in East Germany and Yugo in Yugoslavia – the subsidy problems would escalate and lead to caricature-like ratio of quality and price, with high social cost.

So, if a country is not a leader in cutting-edge industries (like the United States, Japan, Germany or South Korea) – if its people cannot grasp new technologies and organize efficient production quickly and efficiently – its own imitation-based production protected by domestic market often (a) fails; (b) if it

does not fail, it makes products with questionable ratios of quality and price, particularly if they are technologically-intensive; and (c) prices acceptable for buyers must usually be ensured with subsidies, which are nothing but spilling capital from more productive to less productive segments of the economy. This usually destroys the value and slows down economic development. Of course, this does not mean that the imitation strategy will always fail. There are successful examples, resulting from a happy combination of circumstances. But there is a faster way.

#### OWN PRODUCTION BASED ON CONTRACTS

Foreign direct investments (FDI), license agreements and similar arrangements ensuring quick transfer of knowledge (including organizing production in the field, not just blueprints and documents) are the best way of surmounting the limitations of the first model. Based on this model, China launched its industrial growth in the 1990s. Vietnam and India followed suit. Turkey, too. The model was applied particularly well in Central and Eastern Europe. In this century, Czech Republic, Poland, Slovakia and Hungary blazed the trail; all they had to do was to improve the industrial tradition that they had always had, particularly Czech Republic (Bohemia and Moravia were very industrialized way back in the days of Austria-Hungary). Croatia had such potentials, but it failed, because in the early 1990s it was at war while the abovementioned four were busy attracting FDIs, and it joined the EU nine years after the first wave of enlargement (in 2013).

Although the effects of this model are usually observed from the statistical point of view – how many jobs will a foreign investment create – its long-term benefits are much more important. Establishing own production based on contracts should be understood as a knowledge accelerator: after a while, many managers, engineers and workers will move from their original jobs in production to some other companies. They will also start their own businesses and will apply the experience gained in the meantime. It is the essence of development.

The contract-based own-production model is often criticized because its critics do not understand how hard and time-consuming it is to produce one's own practical knowledge from the scratch. If we assume that production of

knowledge is not a problem (it is an assumption that defies the entire experience of Western civilization), then it seems that the model of own production based on contracts has some limited and potentially negative effects. The fact that enterprises are owned by foreign companies is perceived as a problem (they are “extracting our profit”) and economic argument is perceived as the only motivation for own contract-based production (lower cost of labor, lower environmental standards and safety-at-work standards). Those with such perception do not realize that profit – return on capital – is actually compensation for transfer of knowledge and, even if the knowledge content in production is low, positive effects are materialized in the form of employment in sustainable and competitive types of production, which exerts pressure on wage and salary growth in domestic market.

Thus, if we ignore the role of knowledge in creation of value and the dynamic nature of its spillover, economic relations are reduced as a zero-sum game – a game of distribution and redistribution. In this case, it all comes down to power relationships. Mercantilism and Marxism are two best known ideas based on this assumption.

Mercantilism is important for this subject. It is an idea that marked the Middle Ages and the period of colonialism. There was no significant technological progress in those days (actually, there was, but not as much as in the period of modern economic growth that started in the late 18<sup>th</sup> and the early 19<sup>th</sup> centuries). Trade expanded and became globalized – this was the principal mechanism of development before the era of major technological innovations in the First Industrial Revolution at the turn of the century. During the colonial period, the motivation for development was not that much to expand markets as it was to control the chains of raw supplies and labor (slaves) that was in short supply. Modern growth after the First industrial revolution abolished this slavery-based model from the mercantilist times. Coincidence or not, the first case when a slave approached the court and won a lawsuit against his “owner” – and was immediately freed – took place in Scotland the same year when the famous Scottish philosopher and economist Adam Smith published its seminal work, *The Wealth of Nations* (1776).

The most important mercantilist postulate, or goal, is that export exceeds import. In the days of the metal coin standard, this meant that the state – or the sovereign – uses the surplus of international revenue to ensure growing accumulation of gold reserves in the treasury. The collective fascination with

gold originates from those days. Even today it is discussed in great detail when will a central bank buy or sell gold, despite its negligible share in the monetary reserves. Even more resilient is the fascination with export exceeding import, because people intuitively use the idea of deficits and surpluses on the household and company level and apply it to society, forgetting that, in the long run, the only thing that matters is how knowledge is produced and distributed.

## IMPORT

Unlike the mercantilist doctrine that perceives import as a bad thing, from the perspective of society as a “machine” for production of knowledge, import is presented as input of the packages of the materialized and condensed knowledge that we are not capable to produce, or to produce efficiently enough. The more packages of knowledge we export, more we will be able to import, and the quantum of knowledge in society will grow.

In the mid-18<sup>th</sup> century, Adam Smith was among the first ones (not the very first) who realized that society could benefit much more from free trade than from the mercantilist doctrine which was then packed in the model of British imperialism. He realized that, on macroeconomic level, the costs of maintenance of the Empire were much higher than the benefits of it. On the microeconomic level, he formed his experiences on the stories of his father, a customs officer, who told him about bureaucratic absurdities and corruption that he witnessed at work. Smith’s famous work, *The Wealth of Nations* (1776) – reduced by ideologists to a criticism of the idea of market as an “invisible hand” (although Smith mentions this metaphor only once in his book) – can be read as a plea against imperialism.

Of many pivotal ideas explained in this book, we should point out the one about productivity and specialization (division of labor). When making their purchases, buyers in a free market send signals about what people need. The whole production and distribution chain then adjusts to this (price-based) signal in such way that competition of producers and distributors leads to triumph of those who incorporate best practice and the most practical knowledge in their products. Smith got this idea by observing how production in a manufacture was organized.

However, Smith failed to advance a good theory of international trade. The first such theory was offered by David Ricardo in *On the Principles of Political Economy and Taxation* (1817). Ricardo's theory of comparative advantage demolished the intuitive appeal of the mercantilist doctrine, particularly for less productive societies (Šonje, 2017b). Ricardo showed that it doesn't pay for productive societies to produce everything, although they could produce everything more efficiently than others (because they have more knowledge). Simply put, it pays for them to specialize (invest resources) in productions that they are the best at; as for the remaining needs, they should meet them with import. This is an opportunity for the less productive societies to export – there is demand in the productive society for their exports. The less productive societies can use the export revenue for paying the import of – now cheaper – sophisticated products that they do not produce. These products are cheaper because the productive society has increased its productivity by means of specialization. The comparative advantage theory explains how the Croats manage to drive so many technologically sophisticated vehicles that they themselves do not manufacture.

### COVID-19: THE REALITY

Naturally, countries establish trade relationships, particularly on the global scene. The trade war between the U.S. and China has a long-standing history. COVID-19 will merely speed up some of its consequences. A single virus will make the life in China more difficult than the three years of Trump's trade war could: one of the effects of COVID-19 will be shortening of the supply chains because security factors will be introduced in making decisions on organizing production. The role of security in international relations is a variable of which the classical trade models had nothing much to say. A year after the outbreak of the pandemic, it is clear that the romantic view at self-sufficiency, which ignores the problems of knowledge and efficiency, occupied people's minds and media attention for a while, only to disappear with the first relaxation of anti-COVID-19 measures in late spring 2020. However, the pragmatic view at self-sufficiency – in other words, at the structure of global supply chains – remained present in the perspectives of policy-makers, particularly when it comes to relations with China, where important segments of the production

chains using pharmaceutical components and rare metals are located, which we discussed in the second part of this book.

Let us suppose that a production process from a raw material to the final product can be described with degrees from 1 to 10. The 10 would be the sophisticated part of the design and marketing of the final product and the 1 would be extraction of the raw material. The dirty and more labor-intensive part of the work with less knowledge in it would range from 1 to 4. The 5-10 part of the chain would include much more knowledge and most of the process would be performed by sophisticated machines (more knowledge and technology, less human labor). Now let us suppose that the 1-4 part of the production chain is moved back to the domicile country of knowledge for security reasons. The workers at home are more expensive and better protected and environmental standards are high. In a conflict between geopolitical security and relaxation of environmental standards, security will triumph. But knowledge is not questionable; it was initially transferred from the country to which it is now returning in the first place. The engineering skills are hard to forget; they become part of the memory of the profession and are passed on by education and practice.

This “shortened supply chains” model obviously leads to inflation pressure due to returns to the domicile countries of knowledge, because at the moment there is no one who can make industrial components cheaper than the Chinese. But the world is big and dynamic. Not everything will return home soon. There’s India and – in the perspective of the whole 21<sup>st</sup> century – there’s Africa, too. Current problem of “Chimerica” – the globalization model based on the China-America relations – does not mean the end of globalization. This is why forecasts about global relations are a thankless task; value chains will adapt to any change in geopolitical relations. Trying to achieve extreme forms of self-sufficiency is one thing – that’s the third horseman of the apocalypse. Carefully influencing the structuring of supply chains while keeping in mind international security aspects is another thing. So, let us go back to that crucial moment when panic enabled one idea – the idea of self-sufficiency – to occupy people’s minds during that short period when the borders between EU member states were de facto closed.

## SELF-SUFFICIENCY AS A HORSEMAN OF THE APOCALYPSE

The countries with low innovation capacity and without memories of the days when they could compete internationally are more prone to the devastating effects of this idea. Although such countries can increase their living standards only if they are open (because their internal market is too small and/or they lack knowledge for efficient production of most of modern things), the galloping of this horse will be heard when the naïve ideas such as “from farm to table” become widespread and when strong financial and political interests become attached to them.

The pandemic and lockdown can facilitate this in several ways. First, they can change the global economic, intellectual and ideological environment. If the whole world becomes less innovative and efficient and if the dominant ideas and interests become focused on distribution rather than on production, this will also reflect on the ideological and political environment. Interest groups and subsidy seekers will have less problems achieving prestige and influencing political decisions.

Second, the pandemic and lockdown can prevent normal production; when people cannot prosper with their work, they naturally try to improve their position by competing in distribution (fighting for the remaining crumbs).

Third, the countries which are successful in containing the virus and are surrounded by the countries where the virus is still spreading, will tend to remain closed or half-closed for a longer period. This is the outcome that we saw in Australia and New Zealand in the second wave of the pandemic.

All these three ideas were present in society, not just in Croatia, at the time of the initial shock caused by the pandemic. They were not dominant even then, to say nothing of today. Self-sufficiency could attract the attention of the public and policy makers for a longer period of time only if some powerful group centralizes power and starts printing helicopter money, if the EU indeed becomes discredited, if democracy deteriorates and if people stop using the opportunities around them in pursuing their life's ambitions and turn to politicians instead, like fledglings in the nest. Still, that critical moment from March 2020, when for a short while it seemed that self-sufficiency was back to the throne of the revived mercantilism, remains as a reminder of how little fear it takes for the idea of self-sufficiency to reawaken and occupy the minds of otherwise very rational people.

## NANNY-STATE

In the 20<sup>th</sup>-century Europe, the concept of nanny-state manifested itself in various malign ideas and forms – communism, eastern socialism, fascism and nazism. Today it is manifested through combined forms of state or political capitalism, from the rigid Chinese model to the political benign liberal-democratic model which is best presented by the nanny-state that redistributes almost 60% of GDP in France and Finland (measured by the share of general government expenditure in GDP).

Nanny-state happens for various reasons. One can be positive – if the government efficiently offers the services that people need and voters readily support. This is how nanny-state comes into being in liberal democracies. On the negative side, nanny-state can become swollen as a reaction to fear, uncertainty and insecurity or as a reaction to the propaganda disseminated by some dictator. In other words, the government sector and the structure of its activities are determined by the demand for government services. Protecting the population is one of the government's main services and this role increases in a society riddled with fear, when people are ready to sacrifice a lot – first other people's freedom and eventually their own. This is a chapter about a world that could happen if fear permanently increased the demand for the services of nanny-state.

### HISTORY AND CULTURE AS DETERMINANTS OF NANNY-STATE

Iceland has become a tourist mecca of the 21<sup>st</sup> century. Its hiking trails are not particularly maintained; except for the most dangerous spots, there are no handrails one could hold on to in order to feel safer. In some places there are signposts that, in addition to usual warnings such as "Proceed at your own risk", inform the hikers that "Iceland is not a nanny-state".

Such signs are there most likely for legal reasons. They are to dissuade one from the idea that, in case of an accident, one could seek compensation from the Icelandic state (because one has been warned). They also have a practical

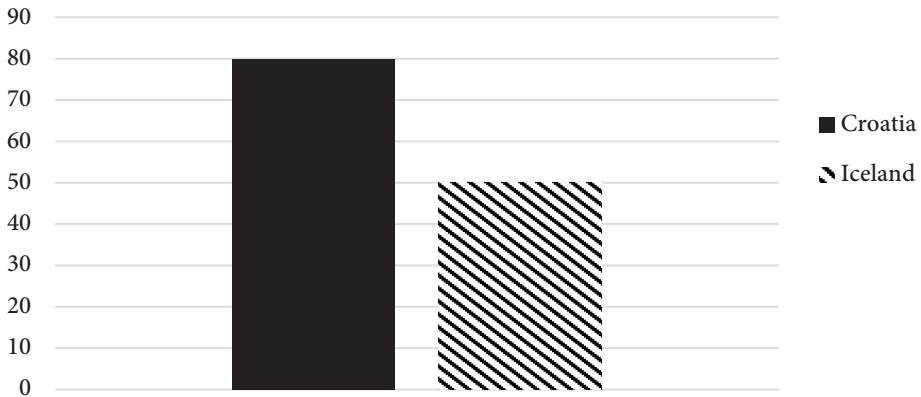


purpose: some 350,000 Icelanders live in a country bigger than Austria with its population of almost 9 million. The Icelandic population is too small for equipping the hiking trails adequately for more 2 million tourists who visit Iceland every year. Sticking some signposts in the ground is simpler than fixing hundreds of kilometers of handrails and ropes in places not accessible by vehicles.

The decision that the state will very discretely care about the security of millions of tourists is part of the culture. It implies that you are free to go wherever you want and do whatever you want – but at your risk.

Cultural aspects of the relationship towards insecurity and uncertainty are crucial for understanding the countries' different reactions to the coronavirus. This part of culture can be measured. Figure 22 shows a comparison between Croatia and Iceland, using the Hofstede index of uncertainty avoidance. The index analyzes our relation towards the future: do we want to control the future or are we willing to embrace it no matter what happens? A strong desire for controlling the future is a feature of the cultures who want to avoid uncertainty. Also, according to Hofstede, the cultures with high values of the uncertainty avoidance index do not tolerate unorthodox behaviors and ideas. Unlike them, the cultures with low values of this index are more tolerant and care more about practice than about principles (see also Rajh, Anić and Budak, 2015). If culture is important for designing of institutions and if it has an impact on different responses to the corona crisis, we could expect that a strong inclination towards uncertainty avoidance would result in a radical lockdown. We will show here, however, that the relations are far from being that simple.

Not every fear-induced behavior can be explained by culture. If a lion charges at you, fear will make you run, no matter if you are a Croatian or an Ice-lander. But culture is imbedded in the formal norms that regulate social life – laws, constitutions and typical collective decisions. This is why the formal norms inherited from the past shape our reactions in an uncertain situation. Along these lines, we can assume the coronavirus caused equal fear in China, Croatia, Hungary and France, as well as in Sweden and Iceland. However, the reactions of societies (citizens and leaders) to the same dose of fear are different, because the constitutional and legal limitations and the political culture arising from the tradition are also different.

*Figure 22. Uncertainty avoidance index: Croatia and Iceland*

Source: Hofstede-Insights, 2020

For example, China has applied a model of control by a single Party center which, among other things, protects people. In France, a single man – the democratically elected president – decides upon the measures without many limitations. The similar model is found in Serbia, which was among the first countries to introduce curfews. At the outset of the crisis, the Hungarian parliament delegated essential authorities to the almighty prime minister *Orbán*, known by “successful”, decade-long protection of his people from the European Union on the one hand and from “Moslem invasion” on the other. In Croatia, politicians are hiding behind the all-powerful National Civil Protection Authority, most of the members of which come from the ministry of interior (at the outset of the crisis, minister of interior started appearing in public in his uniform – true, not a police uniform, but a civil protection one).

## OBJECTIVE THREAT

In the case of COVID-19, it is not easy to tell was it really a lion attack or fear had magnifying eyes. If a threat, and also a success in containing the virus are defined as minimization of COVID-19 death rates, Central and Eastern Europe were very successful in achieving this health-related goal during the first wave, unlike most of West European countries. However, in autumn and winter 2020, during the second wave, all countries of Central and Eastern Eu-

rope were severely hit. At the time of completion of this book, Czech Republic and Slovenia rank second and third in the EU, just after Belgium, with their mortality rates of 1.8 per mille (approx. 1,800 deaths per 1 million). Following them are Montenegro, North Macedonia, Bosnia-Herzegovina and Bulgaria (their death rates of 1.5 per mille are comparable with the ones of Portugal and Spain). Croatia's death rate of 1.3 per mille is comparable with the ones of France and Sweden. These are very diverse countries which are hard to group geographically, historically, culturally, economically or by any other criterion. And the outcomes will change.

The first wave of the contagion bypassed Central and Eastern Europe because peak came rather late in spring 2020, when seasonal respiratory infections generally fade. The second wave, however, hit them with all its might, showing that COVID-19 was indeed a dangerous respiratory disease. Its seasonal character is similar to the one of the seasonal flu, but its consequences are more severe. This is why most countries recorded excess mortalities that exceeded such excess mortalities of the already known diseases of previous years. In Croatia, for example, the total monthly mortality rate at the peak of the pandemic in December 2020 was approx. 15% higher than in the worst month in previous years (January 2017). In 2020 there were 1.8% more deaths than in 2015, when the highest mortality rate by then was recorded.

We cannot draw conclusions about the efficiency of anti-COVID-19 measures from the numbers of COVID-19 deaths. Czech Republic and Slovenia had much more stringent measures than Croatia, but their mortality rates were substantially higher. Some countries which had not-so-restrictive measures in the second wave (Estonia, Finland), managed to avoid higher death rates so far. Statistic research is inconclusive when it comes to effects of the measures because a series of hard-to-measure factors caused different health outcomes. The factors such as general health and average age of a population, its density, organization of public health system and modes of treatments, individual responsibility and cultural habits (tendency for private gatherings) – they all could have had an impact. There is a possibility that there are some other relevant factors that have not been identified yet.

Consequently, a strong inclination towards restrictions, including the most radical ones such as curfew, is not a result of scientifically proven effects of the measures but of the fear that triggers the “better safe than sorry” logic. And the range of measures without firm scientific evidence is wide enough to allow for

various experiments. Some of the measures, like social distance, hygiene, isolation of the infected and avoiding large gatherings, are not particularly contentious. Battles are fought over the most radical measures, such as ban on leaving home, curfews, ban on travel, shutting down economic activities and closing schools. It is clear that, if you atomize society down to its smallest isolated units (individuals or families), an epidemic can be contained in a few days or weeks, but this begs two questions: First, what to do if the lockdown is lifted before the contagion has been eliminated everywhere (a latent danger of importing the virus)? Second, what are the social costs of a radical lockdown, particularly in the long run? Many countries recorded sudden drops in the numbers of preventive checkups, therapies and surgeries in treatments of other grave injuries such as cancer. Estimates were made of the social losses caused by suspension of normal education of children. In other words, there are very few countries that, after one year of the pandemic, can safely say that they have found the right way of balancing health, safety and freedom. This is why simple moral rules such as unconditional application of the principle “better safe than sorry” are of no big help, primarily because of uncertain long-term consequences.

One of the most important such consequences is a long-term change of relationship between an individual and the authorities manifested as structural strengthening of demand for the services of the nanny-state. This is because the growing number of anti-pandemic measures that prevent movement of people and normal economic and other activities will result in more compensation measures intended to avoid the worst consequences such as loss of income or job. This compensation increases budget deficits and public debt and diminishes the possibility that society will have enough resources for introducing such measures again as a response to some similar crisis in the future.

The problem of excessive reliance on the nanny-state surmounts the fiscal problems. It goes without saying that a state that introduces a lockdown and shuts down economic activities must compensate for a substantial portion of people's incomes, just like it pays soldiers during a war, only now people are not paid to go to the frontlines but to stay at home instead. At the time of completion of this book, Croatian government had paid for wages and salaries in the private sector approx. 4% of GDP via labor market support measures. Similar amounts were paid in other European countries which preferred financing non-dismissal of employees during lockdown to increasing unemployment benefits after layoffs.

But the nanny-state problem cannot be reduced to a few percentages of GDP. It penetrates deeper into the forming of the political and economic structure of society: how will the dramatic growth of government expenditure and public debt affect the existing economic structure which already depends on the public sector? This, in turn, is affecting the efficiency of the European economy.

Croatia is not the only European economy where the following simple calculation can be applied: the general government budget expenditure before the crisis accounted for 47% of GDP; if state-owned enterprises and agencies outside the general government are added to it, the public-sector share accounted for 55-60% of GDP. After the corona crisis, the share could come close to 70%. Can we just shrug off the question about the future of such economic and political structure? Is it not a way to private sector's serious dependence on public sector – something that will hinder the development of the European economy's competitiveness, weaken the impulses for innovation and growth and, possibly, endanger the future fiscal capacities that we will need for the future crises in the 21<sup>st</sup> century? And finally, is it not true that the sharp shock of 2020 and the recovery of the European economy expected in 2021 (slower than the recovery of the American economy) is partially a consequence of the structural weaknesses of the European economy, which could be linked to the suppressed dynamics of the private sector?

#### KEYNES, THE ROLE OF THE STATE AND HOTEL CALIFORNIA SYNDROME

It is only natural that the state takes action when a major crisis occurs and that it tries to reduce the risks and the consequences of the drama. Šimović and Deskar-Škrbić (2020a) showed that, throughout the history, states would assume a robust role in crises like this, and that such a role would stick for good. In the times when public sector was negligible, this meant expansion of very useful public functions such as public health care and public education. In another text on John Maynard Keynes's ideas, Deskar-Škrbić (2020) presented the reasons why a society may find it rational to rely on the state during a crisis: investment horizons are getting shorter, entrepreneurs cannot form rational expectations, risk perception is escalating, innovations are coming to a halt and the state is the single actor with enough power to try to change it.

If we return to our pandemic-riddled world, the principle is the same. Given the uncertainty that was widespread around 10 March 2020, reacting by introducing strict measures was rational: as a response to a crisis, you cannot beat a short and powerful state intervention in the economy.

However, entering a marriage is easier than leaving it. This is the well-known problem of asymmetry, sung about long ago in the famous *Eagles* song, *Hotel California*: “You can check out any time you like, but you can never leave”. This could be applied to the role of state in our lives. Everything we have witnessed these days – from fear of relaxation of anti-COVID-19 measures to fear of excessive public debt in the future and the changes the nanny-state will bring to society – can be described with the *Hotel California* syndrome. Useful state functions were already introduced as a result of the changes that had taken place in the 20<sup>th</sup> century, so it is hard to imagine some new public functions that could be created by increasing the share of public sector up to 70%, 80% or 90% of GDP. It is much easier to imagine inefficiencies in performing public services with a public sector of such proportions.

Keynes didn’t pay much attention to *Hotel California* lyrics (having departed this world in 1946, he could not hear them). Although he officially claimed that “in the long run we are all dead”, the Englishman implicitly believed in the long-term rationality of liberal-democratic societies, probably because of the tradition he had grown up with. The question is, however, is it possible to have such a belief if you happen to be born, say, in the Balkans, where no one has any illusions about the long-term rationality and liberal spirits in the government?

## THE END OF DEMOCRACY?

To most epidemiologists and laymen, the radical lockdown seemed an excellent solution for the virus of which they had known nothing in the beginning. The Chinese approach was based on full-scale suspension of the so-called non-essential activities (almost all of them), forcing people to stay at home and using electronic surveillance to keep track of them, threatening the violators with long-time imprisonment – a typical instrument of repressive regimes. Not surprisingly, the lockdown neatly dovetailed into the Chinese political system. Surprisingly, it also inspired policy makers in Western countries.

It became clear in the first weeks of the pandemic that Western countries could not apply the Chinese model in its entirety. Faced with democratic limitations and different cultural habits of their citizens, they opted for a wide range of solutions as early as during the first lockdown, in March 2020: from autocratic measures such as curfew in Serbia and delegating part of the parliament's authorities to the prime minister in Hungary to weaker measures with adhering to democratic achievements, such as in Sweden, Estonia and Japan.

At the very beginning it was noticed that young democracies exhibited major departures from the democratic decision-making standards. But even some older democracies shared this problem. In the United Kingdom there was a scandal about the role of Sage, a secret counselling team, in the development of the anti-COVID-19 measures (Carrell et al., 2020). In February 2021, a scandal broke out when it was found out that German minister of interior Horst Seehofer had been outsourcing counsellors for propaganda activities intended to scare people. Departures from democratic practice took place everywhere, which was allegedly justified with the emergency and efficiency of decision-making in the times of crisis. Not the first and not the last time in history.

The question is: to what extent were justified the fear and sense of urgency that gave rise to modification of the political processes and actions that, in normal conditions, would be considered undemocratic? The question takes us back to the “Chinese approach”. Was it really so ideal and did it really yield such great health outcomes as the lockdown supporters would have us believe, or could similar results be achieved with less restrictive measures, such as the

ones introduced in, for example, Sweden, South Korea, Japan, or Croatia in the second wave?

Michael Muthukrishna (2020) from London School of Economics published a debate on this subject after he had found a connection between the collectivist cultures and success in the fight against coronavirus. It was a work by Gelfand et al. (2020) that inspired him for this debate. Having analyzed the impact of the degree of economic development, population density, inequality, age of the population and the level of authoritarianism of cultures on health outcomes, the authors found out that the interaction of an efficient government and cultural tightness led to better health outcomes in the fight against the coronavirus.

Enough has been said about the importance of efficient government. It is a thesis by Fukuyama (2014): efficient administration is of fundamental importance for a successful society. The liberal-democratic organization system draws upon the fundamentals of an efficient state. Efficient administration is a much older social invention than liberal democracy. Without efficient administration, democracies often turn into corrupt caricatures that no one expects to succeed in anything, least of all the fight against the pandemic. Cultural tightness, on the other hand, is a less known but equally important factor in the duo that ensures efficient control of the epidemic.

Cultural tightness is the term that describes the control of people's behavior through the pressure of other members of society who criticize, judge and stigmatize individuals whose behavior differs from the accepted social norms. It is an important element of the collectivist culture that Muthukrishna writes about. Cultural tightness does not imply social tendencies to undemocratic, authoritarian solutions. On the contrary, Muthukrishna refers to the compatibility of cultural tightness and democracy: cultural homogeneity or sharing similar social norms facilitates the development of democracy. Excessive cultural differences cause divisions among people, stir up conflicts, prevent dialogue, and make democracy non-functional. Along these lines, Aktaş et al. (2015) failed to find a connection between authoritarian cultures and health outcomes, but they managed to find that interaction between an efficient government and cultural tightness leads to acceptance of autonomous (instead of charismatic) leadership.

If you still find this confusing, keep in mind that cultures with a high tendency to exert pressure on individuals do not have to be dictatorships – and



most of them aren't. These cultures include Australia, Japan, Greece, Hungary, Germany (specifically, former West Germany, where cultural tightness is stronger than it used to be in former communist East Germany). China is a country with a high degree of cultural tightness and is also a dictatorship. On the other hand, the cultures with low cultural tightness include very different countries like Austria, United Kingdom and United States.

In both groups of countries there are those which fought the contagion successfully; in both groups there are differences in the stringency of the measures applied. The relations are very complicated and connections between cultures and health outcomes cannot be seen at first sight and with the help of a simple statistical analysis. This is why debates about the relations between lockdown, democracy and health outcomes in the pandemics will certainly last for a few more years. Social sciences have only begun to address the pandemic phenomenon and the reactions to it and will certainly have a say about different national outcomes.

For example, in the countries with strong cultural tightness and efficient authorities with less stringent measures, solid health outcomes were achieved in Japan and Estonia (mortality rates of 0.06 and 0.4 per mille, respectively, by the end of February 2021), but a much poorer outcome was achieved in Sweden (COVID-19 mortality rate of 1.3 per mille). In the countries with weak cultural tightness and efficient authorities, there was a solid outcome in Austria (1 per mille) and weaker outcomes in the United Kingdom and United States (1.8 and 1.5 per mille, respectively). China, North Korea and Cuba are among the least hit countries in the world according to their official statistics, but nobody believes their figures. Even if they were true, there would still be the question of the price their societies had to pay in order to achieve such an outcome: is it worth paying a high price of totalitarianism?

If Muthukrishna's ideas about the crucial role of cultural tightness and efficient state in the fight against the pandemic contain anything that will be confirmed by future research, then the next cycle of research will be able to analyze whether efficient administration and cultural tightness coupled with less stringent measures could produce a sufficiently good health outcome that will not require a lockdown relying on Chinese authoritarian approach. Otherwise, efficiency of the radical lockdown strategy, if proven, could be a manifestation of liberal democracy's weakness in finding its own way that could balance health, security and freedom.

## DEMOCRACY'S NEW ROLE

Copying the Chinese approach is not the biggest threat to liberal democracies. Neither is the economic decline caused by it. The biggest threat to the democratic development lies in complex interactions between the aroused horsemen of the apocalypse. Remember the remaining four: helicopter money, discredited European Union, self-sufficiency and nanny-state. All of them mean erosion of civil democratic control, aside from helping promote the nontransparent doctrine (and interest) of the government counselors who promote lockdown; a major threat lying in it is the possibility that society moves to a wrong political direction. For example, monetary financing of budget deficit without brokering of financial markets (helicopter money) creates possibilities for nontransparent preferential treatments and redistributions of values that can boost inequality and that lack the legitimacy acquired by political voting. The subsidies required for realization of the concept of economic self-sufficiency imply spillover of values from productive to non-productive economic activities entwined with the interests threatening to lure the elected politicians. If fear and demand for protection are constantly being promoted instead of constant questioning of the evidence on which politics should be based, society is facing a long-term deceleration of economic growth and the weakening, perhaps even abandoning, the principles of liberalism and democracy.

Economy is an important part of such transformation because intimidated passive citizens, besides having low capacity for resisting the measures promoted by means of strong propaganda and moral blackmails, lose their entrepreneurial impulses and readiness to take the risks on which growth rests. In this case, more and more people and initiatives turn to the government which remains the only actor in the society with the capacity of initiating economic growth. Government investment suddenly becomes the only way of maintaining investment activity. The salaries in the government sector are presented as the crucial source of domestic demand. Against the backdrop of such relations, private sector collapses and the public one, financed with the exploding public debt, is prosperous, at least in the short run, so the structure of the economy swings in the direction of the latter. This also implies a change in the political structure, because the capacity for democratic control of public sector – which is growing relatively larger than the private one – is gradually weakening.

Democracy, in the true sense of the word, is the only mechanism that can control the swollen public sector and balance its relationship with private sector or private sphere in general. Although it was not easy to achieve even before, after the pandemic it will become even more difficult. The relative size of the cake is now getting bigger, in terms of economic resources offered on the national menu to the public sector. Like a glue, public resources will attract even more private interests. The already affected relative appeal of employment in public sector compared to that in private sector will increase additionally – because jobs in public sector are obviously more stable and protected, results are less measured and controlled and, in many European countries, average salaries in public sector are higher than the ones in private sector. In addition, doing business with public sector can also attract talented entrepreneurs because the demand created by means of public procurement is more stable than the market-driven demand in the times of crisis.

A good democracy could help reduce such political-economic “deals” to a minimum and help organize society on the basis of balance between the private and the public (with a maximum transparency of the latter). But it is also possible that the brave new world wins support of the general public and drags Europe all the way to – political capitalism. It would be a historical triumph of the “Chinese approach”. In this scenario Europe and China would become more similar in this century – not identical, because they have very different histories and political systems, but swelling of public sector to the proportions beyond democratic control would mean convergence of the two systems.

The elites that could benefit from such swelling of the state would certainly find a common ground that would establish a new political and economic model. Besides by relentlessly strengthening democracy and public control over the government sector, such an outcome can also be prevented by a responsible fiscal policy that – inevitably – serves as the main leverage for mitigating the economic consequences of the crisis.

## GOVERNMENT MEASURES, FISCAL CAPACITY AND LONG-TERM GROWTH

The initial fiscal response to the corona crisis in Europe was stronger than the response to the previous crisis. The ratio of public debt and GDP in the Euro Area grew from 84% in 2019 to 98% in 2020 – in other words, by 14 percentage points (Haroutunian et al., 2021). In the previous crisis, a similar growth of public debt (from 64.9% to 80.5% of GDP) took place over a period of two years (2008 – 2010).

The second important difference between the two crises in the 21<sup>st</sup> century lies in the structure of fiscal expenditure. The lockdown required interventions in labor market in order to retain subsidized jobs. There were no such interventions in the crisis of 2009. The growth of unemployment was thus suppressed: the unemployment rate in EU27 grew from 6.6% in February 2020 before the first lockdown to 7.5% in December 2020. It is a very mild growth of unemployment, given the GDP drop that exceeded 6% in 2020. In the period from 2008 to 2014, the unemployment rate in the EU grew from 7.2% to 11.4%, although the GDP drop was lower than in 2020.

The U.S. also used strong fiscal incentives, but they were directed to mitigation of the social consequences of unemployment and decline in income. The U.S. labor market continued to operate freely throughout the crisis, so the unemployment rate escalated during the first wave of the restrictive measures. As the Americans did not subsidize job retention schemes, their initial unemployment rate escalated dramatically – from 4.4% in March 2020 to 14.8% in April. But the shock was short-lived: the unemployment rate soon began to drop and by the end of 2020 it became lower than the one in the EU27: it was 6.7% and falling.

Despite dramatic fluctuations of the number of unemployed, the U.S. economy handled the corona crisis better than the EU economy. According to the preliminary estimates by the U.S. Bureau of Economic Analysis (BEA, 2021), GDP dropped by 3.5% in 2020. In the final quarter of 2020 it was only 2.5% lower than in the final quarter of 2019. According to the preliminary estimates

by Eurostat, the EU's GDP dropped by the much higher 6.2% (6.6% in Euro area). In the final quarter of 2020 it was still 4.6% (4.9% in Euro area) below the level of activity in the final quarter of 2019. The U.S. economy might return to the 2019 level as early as in 2021, while the EU could make it in 2022 in the best case. Chances are that the U.S. economy will have dealt with major 21<sup>st</sup>-century crises with much less scars, similar to previous crisis.

But there is a dilemma whether these smaller drops of the U.S. economy in crises actually result in a permanent developmental advantage. If GDP data over a long period are observed, there are major differences. According to Eurostat's *GDP per capita at purchasing power standard*, in this century, the EU is not lagging behind the U.S. that much anymore; America's advantage dropped from 48% in 2008 to 40% in 2019. According to Maddison Project database (version 2020), the real GDP per capita based on purchasing power parity in the U.S. grew by 20.6% from 2000 to 2018, while the same indicator for Germany grew by much higher 38.4% and for Netherlands by a little higher 25.3%. However, many European economies are lagging behind the U.S.: in this century before the corona crisis, this indicator grew 15.3% in France, 15.7% in Spain, only 5% in Italy and 12% in Greece. Obviously, the countries of Southern Europe not only caused the larger EU's drop in the corona crisis and in the one that escalated in 2009, but they decelerate the growth of EU economy in the long run.

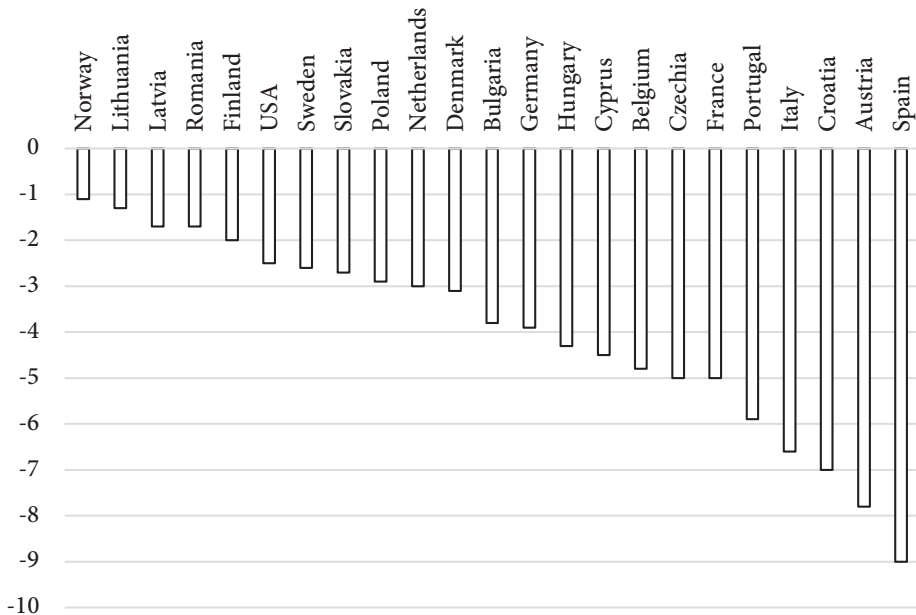
If we take a look at crisis periods only, we can notice the same pattern: for example, Germany recorded a bigger drop of GDP in 2009 (-5.7%) than in 2020 (-4.9%). The same goes for Sweden (-4.3% in 2009 as opposed -2.8% in 2020). In France it was the other way around (-2.9% in 2009 and -8.1% in 2020) and so was in Spain (-3.8% in 2009 and -11% in 2020). The southern countries recorded a bigger drop in the corona crisis than in the crisis of 2009 due to the relatively higher importance of the sectors that were hit worst by the corona: transport, catering and tourism. Croatia also fits in this picture with its drop of 7.3% in 2009 and 8% in 2020.

In Northern and Eastern EU, economic growth is still vibrant – to all appearances more dynamic than in the U.S. – while in Southern EU it is suppressed, not just because of the short-term crisis shocks that hit harder the economic sectors which are more relevant in the South; long-term growth rates are also much lower. Some possible explanations include weaker institutions,

less innovation, more prominent negative demographic trends (ageing population) and migrations.

The short-term differences between countries manifested in this crisis can be seen in Figure 23. It shows the estimated level of economic activity in the fourth quarter of 2020 compared to the fourth quarter of 2019 in the EU countries. A smaller or similar drops like in U.S. (-2.5%) were recorded in northern EU countries and Romania. It is because the small group of South European countries that the EU is substantially lagging behind (France, Portugal, Greece, Italy, Croatia and Spain). Interestingly, Austria joined this group of “laggards” in this crisis. After a longer period of correlation, the economic dynamics in Austria recently “divorced” from the one in Germany, with which it is closely connected. Again, one of the reasons is the relatively great importance of transport, tourism and catering for Austrian economy.

*Figure 23 Change of real GDP in the period between the last quarter of 2019 and the last quarter of 2020*



Source: Eurostat, BEA

## FISCAL POLICY LIMITATIONS

The differences between member-states are often used as an argument that regional difference in Europe can be reduced with a more intensive fiscal expansion and redistribution (transfers to the less developed parts of the Union). Two arguments are usually used to support this recommendation. First, European fiscal expansion, although stronger than in 2009-2011, is still weaker than those in the U.S. and Japan. It is expected that gross public debt of the U.S. will grow from 107% to 125% of GDP in 2019-2021, while in Japan it will grow between 236% and 255% of GDP in the same period. This shows that the growth of the ratio of public debt and GDP in the EU is less prominent than in the U.S. and Japan. This makes the advocates of stronger fiscal expansion believe that the EU has a bigger fiscal capacity for increasing deficit and public debt in order to create a stronger fiscal incentive for leaving the recession behind. They point out that there is no reason to fear a fiscal crisis caused by an excessive fiscal expansion. For even if there was such fear before European QEs in 2014 and 2020, the ECB interventions that lead to direct purchase of government bonds have now eliminated this concern and keep interest rates under control.

However, unlike the U.S. and Japan, the EU is not a state. A fiscal expansion any stronger than the one that has turned out to be possible within the existing institutional framework would have to be supported by the voters in all member states, particularly in the North, where most of the net payers to the common European budget live and vote. The opponents of stronger fiscal expansion are warning about the political and economic limitations arising from the EU's specific political structure, while the advocates of a stronger fiscal expansion point out that voters in the North should support and finance common fiscal mechanisms (a larger common budget and public debt) because it is not just a matter of European solidarity, but is also in their interest: accelerating growth in the South, stimulated by joint fiscal expansion, would allegedly increase demand for products from the North, and everyone will benefit from it.

When advocating a bigger common treasury, fiscal optimists bypass the question why the countries like Greece and Italy failed to create healthy bases for economic growth in previous public-debt growth periods: why should we expect that some future fiscal tide would be able to solve the problems of these

countries even though it seems that they are of a structural nature? Everyone agrees that economic fundamentals (e.g. institutions, education, innovation) matter, but the fiscal optimists say that reforming them will be easier in the conditions of growth, when the fiscal expansion creates a favorable framework for the growth of domestic demand.

Three arguments can be made against this view. First, fiscal expansion based on weak fundamentals can intensify the problem. It will not intensify the incentive for structural changes. At the end of the expansion period, the country will have increased its debt and the impulse of demand will have disappeared and productivity will have dropped to its pre-expansion levels while the debt will have remained. Second, fundamentals (e.g. education system, demographic trends and migrations) can cause a slower economic growth in the long run and, if the short-term fiscal expansion does not change the structure, the outcome will be higher debt for the same or a lower number of younger citizens whose quality of education will fall behind the quality of education of their peers in more developed member states. Their income perspectives will continue to be poorer than the ones of their peers in the developed parts of the Union, but their debt will be equal or higher than their peers', thus triggering new cycles of migrations to lower public debt member states. Third, as the EU is not a state, the problem of a large debt of any single country opens the delicate question of solidarity and redistribution between countries. It is a threat to the delicate European balance. We witnessed an introduction to this sort of a problem in the case of Greek crisis in 2011-2015. No one would want to see such an episode repeated, particularly with a much bigger country in debt in the main role, such as Italy.

We can conclude the analysis of the countercyclical fiscal policy during the corona crisis by observing that the European fiscal reaction was indeed strong – stronger than in 2009 and stronger than anyone dared expect at the very outset of the pandemic. It is therefore not Panglossian to conclude that this was the best one could do this time. There are three reasons for this: (1) The EU is not a state and voters do not want it as a state for now; (2) There are highly indebted countries in the EU which bear the largest risk; and (3) countries in the EU significantly differ by their developmental fundamentals. Improving economic fundamentals requires certain measure of solidarity, both in terms of joint financing through EU projects and in terms of transfers of knowledge of the best practice of public administration. But this type of reforms is primarily



a responsibility of national governments and societies, because such reforms must arise from the political coming of age on the local level. In the long run, pushing this fact into the background and the common fiscal policy into the foreground cannot end well.

Evidence for it can be seen in an episode that took place in Croatia during the corona crisis. With the beginning of the crisis, debates about the fiscal policy arouse. They ended with an attempt to focus on short-term fiscal policy. This created a bitter social conflict between public and private sectors, at the moment when reaching national cohesion and solidarity in facing an unknown threat was needed.

#### G-MISCONCEPTION: THE CASE OF CROATIA

An economic decline and escalation of the fiscal capacity problem naturally lead to escalation of a political struggle for redistribution of the existing added value. Roughly put, when the well-fed guests leave after the feast, the struggle for the remaining crumbs on the table escalates. But redistribution is not the only function of the state. The production of public goods and the allocation function of the state (together with the stabilization function) have its developmental purpose. For example, building the infrastructure that private sector could not build, public education, health care, security and other services that private sector could not provide due to coordination problems in the market – they all increase developmental potential. But when a crisis threatens development and when the stabilization function becomes the priority, two difficult questions arise: First, should government expenditure be increased, public revenue (taxes) reduced or some other combination of changes in the income and expenditure of the government budget be used? Second, even if an optimal combination of income and expenditure with good prospects for surmounting the crisis is found, how do we ensure democratic support for change?

This problem arises from the fact that every action of the government is tied to some interest – the groups who expect benefits from the change will support it and those who expect losses will resist it. It is the political struggle of the likely winners and losers that determines the amount and structure of public revenue and expenditure much more than economists' allegedly rational calculations of the connections between fiscal expenditure, revenue and growth.

This problem is less manifested when the economy is growing. If the cake is growing, the large slices that remain on the table can be allocated to relative losers and thus soften their resistance. But in a crisis, when the fiscal cake threatens to shrink, not only there are no leftovers, but the losses are deeper and more painful and impossible to compensate. This is why there are two theories about when it is easier for society – and for its public sector in particular – to carry out reforms. On the one hand, according to the slice size theory, the possibility of compensating the losers is bigger in the conditions of growth. On the other hand, according to social homogenization theory, in the times of crises people are more willing to make sacrifices for the sake of the promised “better future”. But these are theories. In reality, no society fits theories.

The outcomes depend on many factors, including political culture and political skills. For example, in Croatia, having a rational debate about the size and structure of government revenue and expenditure has not been possible for quite a while. Debates on the weaknesses of public sector – inefficiency, weak institutions and corruption – were rejected by claiming that the advocates of change have certain interest in it. They were usually accused of demanding changes on behalf of capital, not workers. There was always the label of neoliberalism, too. Any attempt to organize something different and better in public sector (like possible reduction of employees by introduction of new technologies) was labeled as an attempt to abolish the welfare state. Pandemic budget was discussed in such atmosphere.

The purpose of labels was obviously to maintain the status quo. Such labels were particularly popular at the outset of the corona crisis, when there was a chance that the number of clients whose income will be financed from the budget will suddenly rise, because the government had promised to subsidize the salaries of all those who could lose their jobs in private sector due to the lockdown. The question arose if the budget envelope would be increased in order to accommodate the growing number of people who were to receive their salaries from the budget, or would reallocations be made within the planned budget expenditure. So, the struggle for the fiscal leftovers escalated in 2020. This is why the idea that increasing the government expenditure is the only right response to the economic crisis was strongly promoted.

When the corona crisis began, Croatian government budget had to bear the brunt of some half a million private-sector employees who were receiving subsidies for their wages and salaries. It was a third of the total number of employ-

ees in the country. In February 2021, more than 100,000 were still receiving subsidies for their salaries. This extraordinary budget expenditure raised the question where would the wages and salaries of the closed private sector be financed from when the public revenue from taxes and social contributions had been plummeting due to recession.

The thesis that increasing expenditure is the only possible response to any crisis is supported by an intuitive appeal of the public sector unions: If you increase our wages and salaries, we will spend them and thus increase sales, thus indirectly increasing the revenues and salaries in private sector. Because, in the times of crisis, only public sector can maintain or increase its spending; who else would? This thesis, presented in such a simplified way and without an in-depth analysis of the economic and political contexts in which it is offered, can be designated as “G-misconception”.

We will illustrate it by using the following identity, very familiar to students of economics:

$$Y = C + I + G + X - M$$

The identity shows the structure of gross domestic product based on the criterion of the use of final products. On the left side there is the income or gross domestic product (GDP (Y)). It describes the market value of the final goods and services that a national economy produces. This value consists of personal consumption (C); I stands for investments, G is government (public) spending, and (X-M) is the export minus import. Many people, including some trained economists, believe that this relation describes a cause-and-effect relationship, so they conclude: If personal consumption (C) is increased, GDP will grow; if government spending is increased (G – Caution! We will later explain that G comprises only a part of government expenditure), GDP will increase; if investment (I) or export (X) are increased, GDP will increase; and if import (M) is increased, GDP will decrease. Isn't it obvious from the above “formula”?

This interpretation becomes particularly topical in the moments of crises, when the issue of government spending (G) is raised: How do you finance it when government revenue is plummeting and the budget deficit and public debt are soaring? At the first sight, economic theory says that, in crises, G should be maintained or, if possible, increased, but not “cut”. The argument is intensified by the multiplier effect: if G is increased for a unit, Y will increase for more than the unit.

The G-misconception takes place for a few reasons. First, the above equation does not constitute a complete model of behavior of an economy that explains cause-and-effect relationships. It is a macroeconomic identity derived from the general principles of macroeconomic accounting. It means that this relation is, per definition, always applicable, but it does not help us predict what is going to happen.

Let us presume that a ruler who is guided by this equation orders that import be reduced by a certain percentage. According to the above formula, a lesser M should mean a higher income Y. Such interpretation also lies behind the earlier explained ideas of self-sufficiency. But, for example, reduced import of energy, which cannot be produced locally, would result in reduced supply. Industrial facilities will come to a halt and households will not have power in the evening. Also, reduced import of technology – capital goods – will mean delayed investments and delayed growth of productivity. Clearly, the above equation cannot be used as a guide for pursuing economic policy because it does not show the cause-and-effect relations. Those who believe that simply influencing one of the values on its right side will result in an expected change on its left side could face the unpleasant side-effects hidden behind this magic equation.

So, can we imagine a situation in which increasing G will not lead to increasing Y and GDP? Note that  $Y = C + I + G + X - M$  says nothing about how the increased expenditure will be financed. Financing problem is outside the equation. If interest rate increases due to the increase of budget deficit, this interest rate increase could have a negative effect on personal consumption (C) and investment (I), and their summed-up decreases could prevail over the effect of an increase of G (with the multiplier effects included – we will come back to them later). This is why all possible effects should be kept in mind, not just the elementary-school relation expressed by the equation  $Y = C + I + G + X - M$ .

#### THE STRUCTURE OF EXPENDITURES AND OTHER COMPLICATIONS

We should also note that the expression  $Y = C + I + G + X - M$  does not depend on time. The equation is “timeless” – the relation is always applicable, be it a one-year or ten-year period. Accordingly, if a higher government consumption G manages to increase Y in the short run, the question is what does it mean for

the long-term growth. For example, if  $G$  is financed by borrowing, this could diminish the state's capacity for borrowing in the future if it is on the verge of its fiscal capacity (if further borrowing would be hard). In some future crisis, the state may not have a sufficient fiscal capacity for responding to the new trouble. Those who believe in  $G$ -misconception are convinced that this problem can be solved when, if  $G$  is increased by a unit,  $Y$  will increase by more than one (so-called multiplier higher than one). But they usually fail to offer evidence for it. In reality, in small and open countries with a large tax burden, multipliers by definition cannot be big; they are usually smaller than 1 and sometimes can even be negative.

We should also keep in mind that  $G$  does not stand for the state's total expenditure. For example, pensions constitute a general state expenditure, but they are not included in  $G$ , but in personal consumption,  $C$ , when pensioners spend them. The investment expenditure for a school or bridge is not part of  $G$ , but of  $I$ , in which both private and government investments are included. Simply put,  $G$  comprises the expenditure for salaries and material costs paid from the budget. In Croatia, as in most of European countries, they account for approx. 20% of GDP. And it was about the public sector salaries ( $G$ ) that a bitter political struggle was fought at the outset of the corona crisis in Croatia, when the public sector unions became alarmed that the increased transfers to other lockdown-affected groups would squeeze out the growing salaries for public sector employees.

Of course, if civil servants and employees spend their increased salaries, GDP will grow because of increased personal consumption, but in such case there will be no "multiplier effects". And second, if the increased salaries are not compensation for bigger working efforts or results in the production of public services, a political question arises: wouldn't a better public good be achieved if the funds were used for transfers to wider population whose jobs and incomes are threatened by the lockdown, instead of for the salaries of government employees? For example, for pensions, unemployment allowances, social assistance and re-training or for relieving tax or non-tax burdens for companies which continued to work and employ workers? Along these lines, the "father" of fiscal stabilization policy, John Maynard Keynes, tied the government actions in crises to the investment  $I$ , not to the government consumption  $G$ . He believed that government investments had a strong short-term – but

also a permanent – effect on the economic development (because private sector would never make them itself).

In case of a sudden crisis, like the corona crisis, the government should consider all the effects that its fiscal policy could create. It should take care about (1) what will be both short-term effects and long-term effects of its expenditure decisions on interest rates; (2) what will be the long-term effects of these decisions on public debt (fiscal capacity); (3) what will be the effects on total investments; (4) what will be the effects on personal consumption; (5) what will be the effects on the long-term capacity for economic growth, etc. There is not a single reason why one should *a priori* expect that the effects of increased government spending on the speed of recovery from the recession would be stronger than, for example, the effects of reducing the tax burden or the effects of transfers to the wider population hit by the crisis. When the U.S. Congress voted the first pandemic assistance package worth as many as USD 2.2 trillion, its focus was on social assistance, transfers and investment, not on increasing civil servants' salaries. And U.S. begun to recover successfully.

#### MARGINAL PROPENSITY TO CONSUME AND TAX MULTIPLIER

Let us imagine that, in the corona crisis, all the people of one country suddenly start living on EUR 700 per month because they are isolated due to the pandemic. They spend on essentials only. Part of salaries amounting EUR 1,400 on average are financed from government budget (G), and most of this amount will not be spent but rather saved. In that case, G will be fictitiously maintained on the existing level (although real public sector consumption will actually drop because the government sector will also work at lower capacity in lockdown), but personal consumption C will be smaller because of the reduced propensity to consume and increased propensity to save. This is what really happened during the corona crisis, when deposits in bank accounts grew at high rates, but the money was not being spent (velocity of money slowed down). In 2020, personal consumption in Croatia fell by 6.2% and household deposits in the banks grew by approx. 6% at the same time. Similar pattern could be found in many other countries.

Increased propensity to save is natural in the conditions of uncertainty. People save out of precaution. Unlike them, some will become so impoverished

due to lockdown that they will lack funds for their basic needs. This is why it is hypocritical to claim that it is the best for society to increase the most important approximation of the  $G$  – salaries of public sector employees – when part of the money is just being accumulated in bank accounts. Even if these salaries were decreased, nothing would happen to the effective demand. If savings in the budget due to lower salaries in the public sector would be used to finance transfers to those who would use it (spend it) right away, the overall effect on the economy would be positive. This is why we can defend the thesis that a combination of tax relief and restructuring of expenditure for the benefit of the transfers to the vulnerable on the one hand and investments on the other would be a better response to the crisis than the linear increase of government spending for wages at the rates that the public sector unions negotiated with the government before the outbreak of the pandemic.

Croatian government pragmatically combined both approaches – public spending was partly increased and partly restructured, together with relieving the tax burden. Fiscal policy was reasonable but it did not prevent Croatia from becoming one of the member-states with the strongest drop in economic activity in 2020. The principal lesson is that structural factors (e.g. importance of tourism industry) dominate over short-term stabilization factors and that the efficiency of fiscal responses in crises does not depend only on large aggregates such as total government spending, government consumption, deficit and public debt. The devil is in the detail: economic outcomes are equally, if not more, determined by the structure of public revenue and expenditure. The structure has a substantial effect on both the long-term economic growth and on the capacity for efficient short-term reactions to crises.

The corona crisis has shown that an efficient fiscal response to sudden crises depends more on the ability to change the structure of revenue and expenditure than on fiscal aggregates. However, not all countries have the political and fiscal capacity for sudden changes in macroeconomic policies. For this reason, fiscal policy largely remains determined by political inertia, which limits its effects on alleviation of the crisis and economic recovery.



## CONCLUSION: CORONA ECONOMICS

The outbreak of the pandemic fits the description of the situation called external shock by economists. It is a negative and intensive event that cannot be predicted or influenced but one must adapt to it. The contagion – external shock – did not cause economic troubles directly. They were partly caused by the reactions to the contagion. First of all, by lockdown, but also by the ways information was disseminated, which led to panic.

Some of the reactions were understandable and justified. Understandable, because at the outset of the pandemic there was no telling how dangerous the virus really was. Justified, because it later turned out that, before the vaccine was developed, COVID-19 was much more dangerous than “just a flu”. Still, there were also reactions that were hard to understand, even if the initial ignorance and uncertainty were taken into account. The attitude of developed countries like Japan and Sweden, which never even considered copying the Chinese approach, suggests that the troubles caused by lockdown were not unavoidable.

In the years to come, analyses will be made in order to explain the differences in health outcomes from country to country and find out which restrictive measures were efficient and which weren't and how. We can hope to obtain some useful insight into all this before some new, similar menace hits the world. In the meantime, we should try to systematize what we have learned so far.

From the point of view of economic analysis and political economy, three conclusions can be made. First, be it a coincidence or a new pattern, but the first two crises of the 21<sup>st</sup> century have caused a much more intensive fluctuation of economic activity than the economic crises in the aftermath of World War II. The question is, are our institutions and knowledge adapted to respond to increased economic fluctuations?

Second, every external shock fits into the existing geopolitical and political-economic framework. They disturb it, challenge it and change it. When it comes to the pandemic, on the global level, this framework was defined with the relations between China and the West (in other words, between totalitarianism and liberal democracy). On the European level, it was defined with the growing differences between the EU member states and the attempts to find



delicate European balance that would somehow reconcile these differences, balance various interests and, possibly, reduce the differences. The question is, has the pandemic increased or decreased the probability of escalation of political conflicts on both global and European levels?

Third, the pandemic has reminded of the latent presence of authoritarian economic and political “sleeping ideas” in democracies. Sleeping ideas wake up when the context, usually stirred up by an external shock, makes space for their establishment. Helicopter money, discredited EU, self-sufficiency, nanny-state and alleged superiority of undemocratic societies in dealing with sudden crises have crawled out of the Pandora’s Box as a warning that this is neither the first nor the last time that the horsemen of the apocalypse are being offered as solutions for social problems; the question is what we can do to convince the citizens that such solutions are based on dangerous misconceptions.

#### A CENTURY OF INTENSIFIED FLUCTUATIONS OF ECONOMIC ACTIVITY

The crisis of 2008-2009 was caused by the so-called endogenous shock within the financial system. The intensity of that crisis can be explained with the collapse of a series of financial institutions in the U.S. and Europe. Nothing like that had happened since the World War II. The crisis of 2020 was caused by a turbulent reaction to an unknown respiratory virus. Nothing like that had even happened since the 1968 Hong Kong flu. Each of these 21<sup>st</sup>-century crises is characterized by the following: (1) It was an unexpected event that almost no one could imagine (because nothing like that had happened in the past few generations), so no one had an action plan at hand; and (2) There was a major economic decline that was partly caused by unreliable and inconsistent initial reactions to the crisis.

We know today that the consequences of extraordinary crises can be alleviated with non-standard monetary and fiscal policy measures. Their strength must exceed anything seen in the history so far. The fiscal and monetary interventions of a few percentages of GDP were considered robust before 2008. But now, after 2020, we have realized that only the monetary and fiscal bazooka of two-digit percentage of GDP could prevent the social collapse when a real external shock, a “perfect storm”, takes place. Good news is that such an in-

tervention is relatively easy to pull out (because we have monetary and fiscal institutions in place and adequate experience). Bad news is that we still do not know how to return to a sustainable path of economic growth after such interventions.

If we assume that we live in a century of intensified fluctuations, then we must also assume that there will be an extraordinary crisis caused by some new, unexpected plague (a meteorite impact; extended draught threatening to turn fertile fields into a desert; dramatic sun flare; major volcano explosion, or some other such event unprecedented for generations). The countries' ability to find adequate economic responses to such predicaments will depend on their fiscal capacity – the possibility of financing the dramatically increased fiscal deficits. In order for the countries to succeed in this, their eroded fiscal capacities after the corona crisis must recover by the next crisis. In the remaining 2020s, the return to the sustainable paths of growth and sustainable public debt has yet to happen. This path will be full of risks.

If some countries will not have enough fiscal capacities for adequate responses, what can they do to mitigate the consequences nevertheless? In search for an answer, we must keep in mind that developed societies are ageing. This primarily refers to Japan and Europe (particularly to Germany, Italy, Southern and Eastern Europe). We know that ageing population means constant growth of demand for health-care services and likely growth of mortality, but the pandemic has shown something else: the ageing of the population can increase the fluctuations of demand for health care services beyond the proportions. In other words, occasional short-term peaks of demand for health-care services can grow much faster than the long-term growth of average annual demand for health-care services due to ageing of population. The reason for this is the constant growth of share of the vulnerable portion of the population – elderly people with comorbidities. Public health systems are not designed for such large fluctuations of demand. Their inadequate elasticity was the main reason for the sudden moral outburst that some people would not be able to receive adequate health care during the pandemic. Obviously, waiting in line at the entrance to the health-care system increases the mortality rate, so one of the reasons for the lockdown was the intention to delay the spread of the contagion in order to prevent such queues, more than the conviction that it would eliminate the pandemic. We can therefore conclude that investment in health-care systems in order to improve their organization and increase their elasticity in

responding to occasional peaks of demand could relieve pressure on introduction of radical solutions such as lockdown.

Radical restrictions take us to the difficult and still unanswered question of the overall relation of social losses and benefits arising from the standstill of normal life. The question has not been answered yet because no research on all the social losses resulting from the lockdown has been carried out yet. If we remember Table 1 in Part 1 of the book, which concisely presents other, visible and invisible, short-term and long-term consequences of the measures selected for the fight against the pandemic, we yet have to analyze the effects of the lockdown in the form of potential years of life lost due to disturbances in the supply of treatments of other diseases, interrupted education, psychological consequences of the lockdown and reduced capacity for coping with some future crises. We still have no idea how will the pandemic and lockdown affect birth rates. Such analyses are indispensable in order to make a distinction between the threats in which even the most radical solutions could be imposed as the best ones and those in which radical restrictions are nothing but exaggeration resulting from panic. Of course, if a disease much more dangerous than COVID-19 can spread among the people equally fast, we cannot rule out the possibility that a radical, even long-lasting, lockdown will impose itself as the best solution in some future crisis. However, every such solution must be tested – must pass through adequate professional and political filters in order to be widely accepted and thus efficient. Until such filters do not exist and until we witness sudden twists in attitudes and communication of the policy makers and their scientific counselors, use of media manipulations and moral black-mails, curfews and armed police in the streets without adequate explanation will never be accepted as an efficient way of fighting epidemics.

#### THE CENTURY OF REDEFINING THE INTRA-EU RELATIONS AND GLOBAL RELATIONS

In this crisis, the European Union passed the trajectory of a pendulum: economists criticized its initial role because of lack of joint fiscal response; Euroskeptics were announcing discrediting and disintegration, and epidemiologists were expressing their regret for the lack of a single epidemiological response. There were also some sober assessments pointing out the coordinated reaction

unprecedented in European history. Despite the fact that it does not have a single powerful center and that its functioning relies on painstaking compromises between the member states (described earlier as delicate European balance), the EU has succeeded. Still, we should keep in mind that strong fiscal responses on the European and national levels would not be possible if it wasn't for the monetary union. By introducing unprecedented monetary measures (which cannot be qualified as helicopter money), European Central Bank created conditions for undisturbed financing of fiscal reactions in the crisis. The ECB's monetary umbrella was extended beyond the Euro area. Croatia and Bulgaria, the countries that only joined the European Exchange Rate Mechanism and banking union in July 2020, had indirect benefits from European institutions: they had an opportunity to finance their fiscal deficits under the conditions that would otherwise be out of their reach. This possibility showed one important benefit from the European Union which is never emphasized enough: even without a fiscal union, monetary union increases borrowing capacities of the Euro area member-states by enabling them to have access to financing under the conditions that individual countries could not have if they had their own currencies outside the common monetary mechanism. Remember that Greece never left Euro area, although motives for it were very strong.

Criticism of the European Union has now faded but it is not gone. The economists who fail to see many other important variables besides the common fiscal policy – fiscal optimists – continue to insist on fiscal unification, particularly on consolidation of the European public debt, because it is the only thing that they see as a fuel for more fiscal stimulus and a faster economic growth. Epidemiologists who believe that they know the best response to the pandemic keep despairing over the variety of national models of the fight against the virus in the EU. Both are believers in technocratic unity, but this belief relies on turning a blind eye to two facts. First, the diversity of local conditions in the EU often excludes the “one size fits all” solutions. Second, the political nature and history of Europe determine the fact that Europe's strength arises from appreciation of diversity of the member-states and regions. When a complex political entity such as the EU faces a new challenge like a pandemic, the complexity of coordination – which may seem like a weakness at first sight – may eventually turn out to be an advantage that enables natural experimenting with different measures and interventions. The diversity of reactions of national policies encourages close observation, monitoring and analyses, to be

followed by discarding bad solutions and copying the good ones – this is an optimal way of establishing the best practices.

If this diversity of European solutions were suddenly gone and if some small group supported by influential technocratic counselors used the moment of weakness and panic to introduce uniform solutions from the top – as if the EU were some empire or state with dubious democratic traditions – they would provoke bitter resistance on various sides of the Union. Only then could we talk about the disintegration of the European project. In this view, we can safely conclude that the EU has found answers to the challenges of the pandemic.

The relations with China are a more difficult matter. China has indeed become the European Union's most important trade partner, more important even than the U.S., and this importance will probably continue to grow in the future. However, the EU is much more important for China's export than China is for European export; the ratio is approximately 2:1. The expected integration of security criteria in the policy of forming delicate pharmaceutical and commodity supply chains after the pandemic is a much bigger problem for China than it is for the European Union (the Union possesses more knowledge and more diverse industries and can find substitutes easier than China).

Still, the reason for dedicating the central part of the book to China is the fact that the SARS-CoV-2 virus arrived from China, which largely influenced the change of perception of this faraway country. Some elements of the new bloc division of the world and the confrontation of the liberal-democratic and authoritarian society-organization models are impossible to underestimate, particularly while there are democratic regimes in the European Union which openly declare themselves as non-liberal. But the overview of China's contradictions, and even of the weaknesses hiding behind the projection of strength of this country, was important in Part 2 of the book because we wanted the readers to get the sense of the real constellation of power and to be able to tell room for cooperation from room for potential confrontations. The deconstruction of the projection of China's strength does not mean self-delusion or turning a blind eye to the obvious; its purpose is simply to become aware of Europe's own (relative) strength.

Was the reason for copying the Chinese approach to the fight against the virus a distorted projection of China's strength (in addition to the obvious panic that broke out in early March 2020), or was lockdown indeed the only possible response that had almost unanimous support of epidemiologists? The early

decision of the countries like Sweden and Japan not to adopt the Chinese approach casts doubt that there was scientific consensus. This is why the biggest strategic mystery of this pandemic is the answer to the question how could it happen that a radical lockdown – an approach established in a society that (1) has a GDP per capita based on purchasing power parity approximately like the one of North Macedonia or Serbia; (2) that allocates for health care purposes a few times less in real terms per capita than an average European country; (3) that has no tradition of individualism and protection of human rights, but is turning into a futuristic technological dictatorship instead; (4) that has no tradition of open criticism and communication, which is why the local public-health authorities' reaction to the spread of the virus was late; (5) that has no capacities whatsoever for innovations in microbiology, virology and pharmaceuticals comparable with European ones; and (6) that has health statistics and information systems that have no international credibility – how could it happen that a radical lockdown as a solution adopted in such a country was soon adopted throughout the EU without questioning the epidemiological, social and political conditions for successful application of such a solution? Fear can help us understand something, but understanding does not mean justification, especially when even at the time of completion of this book, there are news from an EU member state (Slovakia) that its army and secret services will be engaged in strengthening the hitherto unsuccessful lockdown.

One of the main messages of this book is that the projection of China's strength, which is partly objective, should be balanced with understanding China's contradictions and weaknesses. There is no doubt that China, if it manages to maintain high economic growth rates, could catch up with, say, Slovakia in terms of real GDP per capita in the next ten years or so (Slovakia is at 70% of EU average). It is also likely that, due to its large population, China will become the world's biggest economy in the next ten to fifteen years. This growth will be accompanied by the growth of China's military power that will certainly help the country in realization of its interests and in spreading its values internationally. But it would be wrong to conclude that this is why liberal democracies are facing some special new external threat or an "external enemy". In the international arena one should seek to establish balance of interests. Following this logic, the message of this book is that the weaknesses that we attribute to the strength of external influences usually become visible thanks to them, while they – these weaknesses – are actually deeply rooted in us.

## A CENTURY OF STRENGTHENING OF LIBERAL DEMOCRACIES

Weaknesses of liberal democracies are numerous and the pandemic revealed some of them: “sleeper ideas”. We called them the five horsemen of the apocalypse because they rode out from oblivion in a brief moment in spring 2020, amidst great fear of an unknown threat. These five horsemen – helicopter money, discredited EU, self-sufficiency, nanny-state and the idea of the authoritarian societies’ alleged superiority in the fight against sudden threats – are far from being the only ones that corrode the confidence in liberal democracy from inside. But it is these five ideas that the pandemic context helped spread, so this is why they are in the focus of this book.

The corrosive potential of these ideas will be best summarized if we observe their implications. Helicopter money – the money issued by the will of the sovereign, without agency of the financial markets with competing autonomous entrepreneurs – takes us back to a political structure where political power is highly concentrated and citizens-entrepreneurs subdued to the extent that they do not have to work (they can be isolated) to receive their income. It is actually a model of war economy in which people are paid to stay at home instead of go to war. Its softer subtype is the socialist economy model in which soft budget constraints are at work, cutting the ties between wages and productivity and between profit and survival of an enterprise. As for the idea about a discredited EU, it refers to the weakening of international cooperation and institutions in Europe. This is a step towards self-sufficiency – negation of free trade. Free trade is one of the pillars of every community, including the European Union; it is a precondition for division of labor, growth of production and innovations. Returning to autarchy means returning to fear and poverty. Then we have relying on nanny-state. It is partly a natural reaction to fear. It is also a universal desire for less personal responsibility in one’s life, which can be achieved by means of the strong role of state. There is nothing wrong in this tradition if the intervening government is efficient and transparent. This is found in Scandinavian models and in the German model of an efficient state that relies strongly on social transfers in order to provide social security. But if a large state is not an efficient state at the same time, then corruption and inefficiency bloom under disguise of a welfare state, strongly limiting innovation, competition and economic growth. When fiscalists advocate large expansion



on such basis, we can safely say that corruption and errors in the allocation of capital and labour will result in impaired capacity for innovation and growth in the future. This is why the strengthening of efficiency and transparency of state is the segment in which the EU should seek space for increasing productivity and the living standards of its citizens. And finally, certainly the most important horseman of the apocalypse is the one announcing that sudden and serious threats are best confronted by using authoritarian solutions. History does not support this view. The character of a threat can sometimes be such that a rational response to it requires firm hierarchical organization and discipline, but such a social tool should rest on the values of liberal democracy. We should design it through criticism and questioning (how else would we know that it is the best answer?) and in its application we should adhere to the fundamental principles of freedom and responsibility (how else would we make sure that the people who are to use it are motivated and disciplined?).

In this pandemic one could occasionally get the impression that these principles had been forgotten and that the intrinsic uncertainty and fear had nurtured measures that were hasty, unverified and imposed. Even when it turned out that restrictive measures did not work, many of them were retained or even strengthened, thus deepening social gaps without visible benefits in terms of eliminating or mitigating the consequences of the objectively grave COVID-19 disease. Responsibility was often passed onto citizens, who were allegedly undisciplined and irresponsible. But the truth is, political decisions were often like a wheel falling into a rut: the drivers did not have enough strength to change their course, being afraid they would lose the remaining credibility. Democracy and freedom are the only corrective factors that can institute change in such conditions. And without change, no best solutions can be found. This is why preserving democracy and freedom is essential. Not just because democratic societies are more pleasant to live in, but also because it is very likely that such societies will turn out to be more capable of facing the challenges of this century.



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## ABOUT THE AUTHORS

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## ABOUT THE PUBLISHER



**The European Liberal Forum (ELF)** is the official political foundation of the European Liberal Party, the ALDE Party. Together with 46 member organisations, we work all over Europe to bring new ideas into the political debate, to provide a platform for discussion, and to empower citizens to make their voices heard.

ELF was founded in 2007 to strengthen the liberal and democratic movement in Europe. Our work is guided by liberal ideals and a belief in the principle of freedom. We stand for a future-oriented Europe that offers opportunities for every citizen. ELF is engaged on all political levels, from local to European.

We bring together a diverse network of national foundations, think tanks and other experts. At the same time, we are also close to, but independent from, the ALDE Party and other Liberal actors in Europe. In this role, our forum serves as a space for an open and informed exchange of views between a wide range of different actors.

**The European Liberal Youth (LYMEC)** is a Pan-European youth organisation seeking to promote liberal values throughout the EU as the youth organisation of the ALDE Party and the Renew Europe parliamentary group in the European Parliament. LYMEC is made up of Member Organisations (61) and Individual Members, and it is active across the breadth and diversity of the European continent. LYMEC's central aim is the creation of a liberal and federal Europe.



**International Educational Center (IEC)** is a liberal foundation (NGO) that provides political education and training programmes to citizens and organizations. The IEC works to build capacities of liberal parties in Central and Southeast Europe

by organizing trainings on topics such as: talent management, public speaking, data analysis and campaign planning, campaign management, policy development and many others. The foundation also fosters best practice exchanges between liberal organizations and conducts specialized research in the field of voter behaviour. The IEC is a member organization of the European Liberal Forum and the European Network of Political Foundations. <https://www.internationaleducation-center.com/>





Given the toxicity of the debate all over Europe and the world, this book is erecting a monument to intellectual courage. It is not only attempting to analyse and synthesize available data from various sources in a way that will make sense to non-experts but also, and more importantly, re-establish a familiar degree of sobriety in the public debate.

**Dr. Antonios Nestoras,**  
European Liberal Forum

A testimony of a time and of the historical moment we are witnessing, Corona Economics is a cause for reflection and also a warning about the outcomes that could result from reckless public-policy reactions to a public-health threat such as the now famed corona crisis. Corona Economics not only indicates which economic policies are suggested as a means of containment of the pandemic; it is also food for serious thought about how a pandemic can expose the frailty of modern economies and modern democracies.

**Dr. Višeslav Raos, Assistant Professor,**  
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Velimir Šonje and Kristijan Kotarski's book is primarily a plea for a future in which citizens will be more capable of turning "criminal alternatives" into engineering problems – the problems to which a more discrete, utilitarian and democratic moral calculus will be applicable.

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