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Economic policy in an unstable environment - dilemmas and challenges: Polish and German perspectives

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1 Introduction

The global and European economy have been operating under increasingly unstable conditions for a considerable period of time. Initially prompted by the global financial and eurozone crises, they were later joined by the migration crisis, the turmoil of Brexit and the Covid pandemic as well as technological disruptions, calls for a green transformation of economies and geo-political tensions between China and the USA. More recently, the growing threat of inflation in times of high debt as well as the war in Ukraine and the economic sanctions imposed on Russia in response to it by Western economies have exacerbated the instabilities. How does this impact economic development of national economies and international business relations and what are appropriate economic policy responses at national, European and global level in such unstable environment? These were key questions of a German-Polish research project conducted in 2022 at the German Economy Research Department of the SGH Warsaw School of Economics together with partner institutions from Poland and Germany and with support of the Konrad Adenauer Foundation in Warsaw. Its results were discussed at an Polish-German economic conference at the SGH Warsaw School of Economics on October, 27th 2022. The policy paper summarizes key findings and resulting economic policy conclusions.

After taking stock of the current economic situation in the EU (*section 2*), it examines in *section 3* to what extent the war in Ukraine, the energy crisis as well as the rising aggressiveness of autocratic trading partners mark a turning point in economic policy. *Section 4* focuses on the challenges of rising inflation for monetary policy and the banking sector. *Section 5* highlights selected issues such as developments in digital transformation, challenges of local governments and the role of private economic forecasters for economic policy aimed at combating economic fluctuation. Section 6 concludes.

2. Economic situation in the EU in times of energy crises and stagflation

The economy in European Union was hit hard by the lockdowns and other restrictions imposed during the Corona-Pandemic and has recovered so far only at moderate pace. The seasonal adjusted real Gross Domestic Product (GDP) plummeted in the second quarter of 2020 to nearly 85 % compared to last quarter in 2019. The pre-Corona crisis level was reached only in the third quarter of 2021. However, the expected V-turn of EU's economies did not happen. While Poland was the first economy reaching the pre-crisis level in third quarter 2020, as of October 2022 Spain still remained below the pre-crisis level and Germany only slightly above it.

As Thomas Obst (2022) from the German Economic Institute in Cologne (IW Köln) explained, economies with only short and moderated lockdowns experienced less economic losses than those with strict restrictions. Although Germany had kept its industrial sector, which was already in recession since 2018, open, it was severely hit by the interruption of supply chains. Restrictions in other countries and closed borders led to the lack or delay of much needed inputs. This affected in particular the automotive industry. It is not only highly integrated in global supply chains, but as Piotr Arak from the Polish Economic Institute has shown, also faces ever stricter EU-wide $C0_2$ emission targets that hampers its competitiveness not only in Germany (see also Sinn, 2020), but also in the Visegrad 4-countries which are highly integrated into the European and global automotive industry. In the second quarter 2022, value added of Germany's automotive industry had reached only 78 % of pre-crisis level compared to 96 % in total manufacturing and 101 % in the services sector. Given the hub function of the manufacturing sector in Germany with close relations to the service sector, the resulting losses in value added were transmitted across the whole economy.

The recovery of EU's economy was driven by resuming investment activities, which were seven percent above pre-crisis in the second quarter 2022. Obst attributes the stimulation of investments primarily to EU's unprecedented fiscal and monetary measures. At its heart is the 750-billion-euro “Next Generation EU” recovery package, which aims not only to aid the recovery of its member states' economies but also to boost the green and digital transition.

However, the economic situation in the EU further deteriorated through skyrocketing energy costs and inflation. In particular the prices for natural gas and oil rose sharply. The price for natural gas has increased sevenfold from just under USD 10 per British thermal unit (BTU) in June 2020 to over USD 70 per BTU in August 2021. The oil price grew from USD 74 per barrel in January 2021 to USD 120 in June 2022 and is expected to remain around USD 100 per barrel for the foreseeable future, depending, however, on the effects of the oil embargo against Russia. As of August 2022, inflation, measured by the consumer price index had reached 10 % both in the EU-27 and Eurozone, yet with substantial differences among member countries ranging from 5.6 % in France over 10 % in Germany and 17 % in Poland to 25.2 % in Estonia.

The high energy costs drive up firms' production costs and the rising consumer price inflation weakens private households' purchasing power. In second-round effects inflation can even gain in dynamics if increasing producer prices are passed on to consumers and firms that may not be able to do so may face insolvency. In addition, there is the danger of a wage-price spiral, if employees demand higher wages to compensate for higher inflation expectations. In fact, as Obst showed, German household do have a quite high inflation expectation amounting to 9 % for one year and 5,5 % for the next five years. If this unfavourable environment prevails, in particular with high energy cost, a partial de-industrialization of Germany may follow due the relocation of production. This concerns especially gas-intensive sectors, like chemicals, steel and iron, non-metallic minerals products (cement and glass), refining and coking, paper and printing. In chemicals, gas is one of the major raw materials inputs. For example, Germany's BASF in Ludwigshafen alone requires around 4 % of total German gas consumption.

The economic prospects in EU countries are further dimmed by slowing economic dynamism of the global economy, not the least major in major trading partners such as the United States and China, caused by increasing energy costs, supply shortages and growing geo-political uncertainties. The CBP World Trade Monitor expects a reduction of global economic growth from around 3 % in 2022 to 2.0 % in 2023 (CBP, 2022).

3. War, Trade and Energy Crisis

Energy prices and inflation rates have started to rise already in 2021. For example, the price for natural gas grew from USD 6 per BTU in March to USD 38 in December 2021 and the inflation rate in the EU-27 and Eurozone had reached 5 % already also in December 2021 (Obst, 2022). This indicates, that while the war in Ukraine does negatively affects economic development, it is not the root cause of a number of problems of European economies. It only has revealed and exacerbated a longer looming crisis. And in doing so it questions hitherto held convictions and pursued policies. This concerns, among others, the trade relations with with aggressive autocracies and the design of energy supply.

“When goods don't cross borders, soldiers will" is a phrase attributed to the 19th century French Liberal economist Frédéric Bastiat (1801-1850). It aptly points to the overall political benefit of free international trade as it is based on the mutually beneficial voluntary exchange of goods for goods. Yet, the war in Ukraine has made painfully aware that the idea of the peace-promoting and -keeping role of free trade might only be an illusion, at least in cases of those governments that subordinate the prosperity of their country that results from the mutual benefits of voluntary trade to nationalistic, imperialistic and ideological goals or simply to the preservation of power of an autocratic government. The Russian invasion of Ukraine demonstrates that authoritarian regimes launch wars without considering the will of their peoples or voters.

For Western democratic market economies, this raises the question of how to deal with such countries not only to stop wars, but to prevent them from waging wars and abuse international trade for geo-political goals. As Felbermayr et al. (2021) point out, the economics profession has so far paid relatively little attention to these questions. It has focused almost entirely on the effects of the intensifying globalization in the past half century and on the connection between economic policy and economic effects, but it has often neglected the political goals and effects of policy choices, i.e. that economic policy might be used as “war by other means” (Blackwill and Harris, 2016). For example, investment in infrastructure in or between other countries might be used to the raise the dependency of a country’s supply of strategically important goods from the autocratic country as in the case of Nordstream 1 and 2 between Russia and Germany or in China’s Belt and Road initiative. Another tool used by may be aggressive price policy via subsidized state-owned or backed firms in order to raise market shares of the autocratic economic agents and hence, dependency of firms of other countries. Apolte argues that if these policies are pursued for pure economic reason to earn monopoly profits, the autocratic policy would be predictable. However, if the ultimate goal is to divide the world into zones of influence, then autocratic policy is potentially dangerous and should be counteracted. Apolte suggests considering founding “trade clubs” following William Nordhaus’ (2020) conception of the climate-club. This implies that such clubs impose penalties on nations that do not participate or do not meet their obligations. The simplest and most effective would be tariffs on imports from nonparticipants into club member states hoping that countries acting in their self-interest would either choose to enter the club and/or abide by the rules and standards of the club, i.e. reform their political institutions to enhance overall welfare.

This requires an estimation of potential welfare losses caused by an autocratic country’s defection from international rules and of the probability of the risks that it may do so. Hence, the tariff imposed should reflect the expected value of potential welfare losses. The drawback of his suggestion is that it underestimates the Hayekian knowledge problem in determining the risk and the political economy problems with tariffs. Given that politicians are no omniscient benevolent actors, but pursue their self-interest as anyone else, how can be made sure that the tariff would not be used to promote re-election by serving special interest groups through the protection of their industries from import competition.

With respect to the economic relations to Russia, it is important to note that the dependence of the EU, and in particular of Germany, from Russian gas imports is not solely and primarily the result of bad intentions of a reckless autocratic country, but of bad economic policy choices in the past based on what Hayek (1989) termed “pretence of knowledge.” These choices were eliminating baseload energies such as nuclear and coal in Germany that work all the time and replacing them with renewables that were expanded with huge subsidies. Yet, renewables are intermittent and volatile. Therefore, they need a massive backup for security of energy supply in periods of low wind and little sun. This backup can only come from natural gas or oil, if other, cheaper sources are banned. At the same time, many EU countries prohibited the development of domestic unconventional natural gas (France in 2011, Denmark and Bulgaria in 2012, the Netherlands in 2015, Germany in 2017, Spain 2021). This not only made prices soar for household and industrial consumers[1] which threaten to relocate production outside the EU. It also raised dependence on Russia’s gas supplies (see also Haucap, 2020; Sinn, 2022).

Installing massively more renewables, as suggested by Germany’s minister of the economy Robert Habeck and the President of the EU Commission Ursula von der Leyen does not eliminate the risk of dependence on Russia or other commodity suppliers. Because of their volatile and intermittent nature, even a 100 % solar and wind mix would increase dependence on natural gas, which is still necessary as backup. In addition, this would require huge spending on transmission and distribution investments, which makes the tariff more expensive. And finally, the resources needed for solar and wind power system such as lithium, aluminum, copper, etc. raise dependence on other countries, such as China, that have these resources.

[1] As of March 2022, Denmark and Germany had the highest electricity prices worldwide with US-$ 0.48 s per kilowatt hour for Danish and US-$ 0.46 dollars for German households. By contrast, in neighbouring Poland, and the U.S., citizens paid less than half as much (Statista, Household electricity prices worldwide in March 2022, by select country. https://www.statista.com/statistics/263492/electricity-prices-in-selected-countries/).

While renewables do have a place in a balanced energy mix, they do not have it on their own but as supplement, at least for the foreseeable future. How the economically and ecologically mix looks like can only be found out resorting to discovery procedure of the competitive market process where entrepreneurial choices are disciplined by market prices and the feedback mechanism of profit and loss.

4. Inflation, Monetary Policy and Banking Sector

As with the energy crisis, inflation was already getting out of control in Europe before the invasion of Ukraine. Krzysztof Kalicki and Michał Brzoza-Brzezina have shown that in Poland inflation has increased as early as in 2018 and in the Eurozone since 2020. The object of heated debate in economics is the origins and potential remedies of inflation. Different school of economic highlight different factors driving inflation such as money supply (Monetarism, Austrian School), expectation (Austrian School), cost-push, demand-pull, mark-up (New and Post-Keynesian Theory) or political economy aspects. For the current situation, Michał Brzoza-Brzezina points to an unprecedented mix of supply and demand shocks. On the demand side he identified as crucial factor the huge fiscal and monetary expansion during the pandemic and the following pent-up demand as well as the inflow of refugees from Ukraine. Issues at play on the supply side are in his view supply chain disruptions that occurred in the wake of the pandemic, the energy shock and an outflow of workers (mostly men returning to Ukraine to fight in the war). Admitting difficulties in empirically determining the weight of individual drivers of inflation Brzoza-Brzezina holds that supply factor obviously prevails.

By contrast, professor Kalicki emphasizes the role of monetary policy of central banks that has been persistently expansionary for the last almost twenty years. This becomes obvious when looking at the monetary aggregates M1 and M3 as well as at balance sheet of the European Central Bank (ECB) that has grown from just under €700 billion in 1999 to almost € 9 trillion in 2021 (Schnabl, 2022a). This diagnosis in line with the original meaning and the Monetarist and Austrian understanding of inflation. Originating from the Latin word inflare = blowing up, inflation actually means an expansion of money supply more rapidly that the quantity of total output. That is why Milton Friedman called inflation always and everywhere a monetary phenomenon. This view is largely shared by the Austrian School of Economics, which emphasizes that inflation is in addition driven by the subjective expectations of the future developments of prices. Schnabl (2022a) points out, that besides tightened ecologically motivated regulations the continued expansionary monetary itself might have driven up prices of energy and raw materials, because more money in circulation triggers a flight to real assets, which can include commodities as well as equities and real estate. Moreover, large government spendings to whither the pandemic-induced economic downturn and recently to shield consumers from rising prices have again put a lot more money into circulation. According the Brussels-based think tank Bruegel, by the end of November 2022 €705.5 billion has been allocated and earmarked across European countries to protect consumers from rising energy costs, of which €264 billion has been earmarked by Germany alone (through measures such as fuel discounts, the “Nine Euro Ticket”, or the “Gas Price Cap”) compared to relatively modest € 12 billion in Poland (Sgaravatti et al., 2022). This spending further fuels aggregate demand.

This view is shared by mBank’s Chief Financial Officer (CFO) Andreas Böger with regard to Poland’s monetary policy. He points to the paradox, while on the one hand the National Bank of Poland (NBP) has started to raise the reference rate since October 2021 from zero to 6.75 in October 2022, the government, on the other hand, increases spending thereby counteracting the NBP’s attempt to bring down inflation. From the banker’s view particularly damaging and perceived as an assault on property rights and the freedom of contract is the announcement of so called credit holidays in May 2022 that entitles consumers to postpone repayment of loan instalments until the end of the year, which have soared after interest rates rose to their highest level in more than 15 years. While the rise in rates increased banks’ profits, they have been severely dampened in times of low, zero and negative interest rates which has depressed the margin between lending and deposit rates, the banks’ traditional source of income.

In this unfavourable environment created predominantly by erroneous short-term oriented government policy to maximize votes in the next election, the banking sector’s willingness to grant credit is faltering and the business risk rising. In fact, the problem with the ultra-loose monetary policy is damaging growth. As the ECB has increasingly lowered the cost of financing for companies, they have no incentive to increase efficiency. Before the introduction of the euro, the Germany economy under constant pressure to increase efficiency in response to the steady appreciation of the Deutschmark (Schnabl, 2019). Therefore, Böger pleads for a return to classical ordoliberal policy where the government and central banks concentrate on the provision of a stable market-friendly institutional and macroeconomic framework and minimize regulating daily business processes. Yet, even more than the Polish National Bank, the European Central Bank is caught in a balancing act. On the one hand, high inflation requites a turnaround in monetary policy. On the other hand, the bankruptcy of some highly indebted euro countries such as Greece, Italy, and even France is threating. That is why the ECB has left many loopholes open in the way in tightening monetary policy. An example, is the July 21, 2022 decision of the European Central Bank (ECB) to introduce the so-called “Transmission Protection Instrument”. It shall ensure that the ECB’s monetary policy is transmitted uniformly across the common currency area and so try to prevent a breakup of the euro. crises served as justifications for exceptions that increasingly became the rule.

Moreover, rather than to concentrate solely on price stability, the ECB tries to influence to investment decision through the greening of its monetary policy by including climate considerations in its corporate bond holdings, in the assets it holds as collateral, and in the way it assesses risk (Vollmer, 2022). Vollmer showed among Visegrad countries the willingness of central banks to consider climate issues in monetary policy is low except for Hungary, while the Czech Republic clearly rejects such an idea as it endangers the central bank’s independence. In these countries, the external pressure from societal groups like “Fridays for Future “ on public policy and the perception of climate change as a serious problems is much lower than other EU member states such as Sweden or Germany. Yet, irrespective of the attitude to climate change, Vollmer pointed out that the ECB not only has limited opportunities to support a green transformation, mainly because the stock of sustainable bonds in circulation is still too small. Following the Tinbergen rule, environmental policy is and should note be the task of monetary policy, but of government policy by shaping an appropriate institutional framework for the mitigation of environmental problems.

5. Selected economic challenges

Another urgent challenge for economic policy is the digital transformation. The former member of the German Bundestag and Digital Policy spokesman of the CDU/CSU Parliamentary Group Tankred Schipanski (2022) sees an urgent need for action in the a number of areas of German and European digital policy in times of economic crisis: On the European level these are the regulation of platforms, IT security and infrastructure, new technologies, artificial intelligence as well as fostering innovation. He underlined that the modernization of the legal framework in Germany, in particular § 6 NetzDG and the novelisation of the Law against Restraints of Competition (GWB = Gesetz gegen Wettbewerbsbeschränkungen) serve as templates for the 2022 European Digital Services Act and Digital Markets Act. For infrastructure provision and IT security the German priorities comprise the promotion of fibre networks and digital European sovereignty in key technological areas, the formation of an European cloud policy, provision of sufficient financial sources on European level to strengthen the European market and support of the European software sector. With respect to the promotion of artificial intelligence Tankred Schipanski differentiated between three categories of the risk that have different impacts: The first category are unacceptable risks which involve technologies of social scoring, discrimination and manipulation or indiscriminate prosecution in public spaces. The second category addresses high-risk applications in the areas of critical infrastructure, education, labour market, public services and sensible products. They shall be strictly regulated in future. No regulation is foreseen for chatbots, user-communication as well as small and medium risk cases. The stimulation of digital innovations will primarily focus on special support for start-ups, standardization issues, e-government and rising social acceptance of digital innovations in the population.

Elżbieta Czarny (2022) analyzed opportunities and risks of small and medium enterprises (SME) to engage in foreign digital trade. She pointed out that SME usually do not participate in international trade, especially as suppliers of innovative products in global supply chains. Reasons are higher risks stemming from the smaller size of their production and the shortage of capital. Yet, their smallness can be an advantage in providing digital services. It enables higher flexibility, narrower specializations, the provision of tailor-made services, more targeted product differentiation, closer proximity to customers needs and the occupation of and survival in niche production.

These assets can still be leveraged to large scales, once markets develop fast. Moreover, SME can successfully profit from general effects of digital technology such as shrinking transaction costs or lower importance of geographical locations. Finally, on digital markets the remuneration in the form of information derived from data gains strongly in importance compared to traditional monetary payments. Hence, for market actors data gathering is often more crucial for maintaining competitiveness than the command over large financial sources.

An unstable economic environment requires economic agents and policymakers to base their decisions on sound predictions of the future development. Against this background Katharina Köppl and Lilli Zimmermann (2022) analyzed the quality of forecasts in economic cycles by testing empirically forecasters' propensities to herding in boom and bust cycle. Following previous research findings, anti-herding in boom and herding behaviour in bust periods can be expected due to uncertainty and reputational considerations. They found, that only small effects at the aggregate level are visible with a weaker tendency to anti-herding in economic bust. At the country level the effects are ambiguous that indicate country-specific strategic behaviour in distinct periods of business cycles.

Adam Jarosz (2022) from the SGH Warsaw School of Economics highlighted the role of Government Support Programs for local governments in Poland. He showed that local governments were faced with to large additional expenses during Covid-19 Pandemic while facing reduced tax revenues under high economic uncertainties. The Polish government reacted to these challenges in the short term by providing non-financial support, allowing more flexibility in fiscal policy and releasing debt thresholds. In the long run, Jarosz proposed that financial subsidies and large scale investment programs should support local governments to cope up with economic and financial problems. Thereby, the support of the central government should be focused in the first place on increasing investments and in the second place on a stabilizing revenues of local governments.

6. Conclusion

The unstable environment of EU economies is not primarily the result of unlucky exogenous external factors like the pandemic and the war in Ukraine, but was created by flawed economic policy decisions in the past where for ideological and political economic reasons not only basic insights from natural sciences (Sinn 2022), but also from economics as well as fundamental principles of a social market economy were ignored.

For the leading thinkers and early implementers of the social market economy in post-World War II Germany like Walter Eucken, Franz Böhm, Wilhelm Röpke, Ludwig Erhard or Alfred Müller-Armack it was self-evident, that the heart of the system is and always has to be competition in its function as an entrepreneurial-driven discovery procedure and disempowering instrument. Only free people guided by undistorted price signals and disciplined by profit and losses on markets can discover the most efficient solutions to satisfy the needs of their fellow men. This also includes the demand for a clean environment. Yet, since the global financial crisis of 2008 policymakers in major western economies resorted to the opposite – to more and more interventionism thereby pushing back the market mechanism. Therefore, the Zeitenwende (turning point) announced by Germany's Chancellor Olaf Scholz right after the Russian invasion of Ukraine actually requires not more state interventions but a return to more markets. This includes a return to stability-oriented monetary policy along with disciplined fiscal policies. Yet, within the ECB, it seems more difficult to achieve political agreement to reorient monetary policy toward the goal of price stability than in Poland. Where markets do not emerge spontaneously, because property rights are difficult to establish and enforcement is impracticable due to insurmountable transaction and coordination costs, the second-best choice is to take artificial government measures to bring the price mechanism into play as it has been done in the case of emissions trading rather than to resort to government orders under the pretence of knowledge of what is deemed best for all.

Social hardships that occur in crises and during the return to market principles, because distortions are revealed and misallocations of resources are corrected, must be tackled by person-related government assistance and not by subsidizing and regulating whole industries. Thereby, government aid should be limited to needy persons and be phased out as the crises end. Without the return to these simple but basic principles of the social market economy the danger of what Schnabl (2022b) called “Argentinization” of European economies rises. Argentina was once one of the wealthiest economy in the world. Yet, persistent government deficits financed by the central bank, state-managed credit lending and inflation have ruined the country and left it in a dire situation until today. It is therefore to be hoped that a Zeitenwende of economic policy into the right direction will soon begin in Germany, Poland and other European economies.

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