Olli Rehn: Europe's economy - taming inflation, tackling productivity

Speech by Mr Olli Rehn, Governor of the Bank of Finland and First Vice-Chair of the European Systemic Risk Board, at the 2024 RiskLab at Arcada, Bank of Finland and European Systemic Risk Board joint conference on AI and Systemic Risk Analytics, Helsinki, 7 June 2024.

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Ladies and Gentlemen, Dear Colleagues and Friends,

Good morning everyone. May I also take this opportunity, as Governor of the Bank of Finland, to welcome you today. I am glad to see so many of you here in Helsinki, and of course a warm welcome to all those who are online. Once again, the organizers of this conference have put together an impressive programme, with cutting edge topics and distinguished speakers. It is a great privilege to share my thoughts with you today.

Let me begin with yesterday's news – literally! That is, yesterday we decided at the Governing Council of the European Central Bank to reduce the ECB's key monetary policy rates by 0.25 percentage points.

What then is the story behind this very newsworthy decision? First and foremost, we have made significant progress in disinflation since our last rate hike in September 2023. Inflation has fallen by more than 2.5 percentage points, and the inflation outlook has improved markedly. Barring further setbacks, for instance in the geopolitical situation and energy prices, or in wage developments for that matter, inflation is projected to converge to our 2% target in the medium term.

Euro area economic activity is showing increasing signs of recovery, and the labour market has remained robust. The growth outlook was revised upwards yesterday, which is obviously good news.

Looking ahead, the ECB Governing Council will continue to follow a data-dependent and meeting-by-meeting approach when determining the appropriate policy stance. We will set our rates based on our analysis – at each Governing Council meeting – of three parameters: the inflation outlook, the dynamics of underlying inflation and the strength of monetary transmission. And we are not pre-committing to any rate path.

In every meeting we also assess the risks to financial stability. In this regard too, it is clear that today geopolitics is the main risk that may cast a shadow over financial stability in Europe and more globally.

The European Systemic Risk Board, the ESRB, monitors geopolitical developments closely, as these could act as a trigger for many of the key systemic risks identified in the European financial system.

Let me say a few words about the ESRB.

Its core task is to contribute to the prevention and mitigation of systemic risks in the European context. Experience shows how important it is to understand and monitor risks in an increasingly complex, interconnected and continuously changing financial system. One key requirement to succeed in this respect is to have access to high-quality data – without data there is no visibility regarding risks, and without proper analysis it is hard to develop mitigating measures and policies.

By the end of this year, the European Commission will report to the European Parliament and Council on whether there is a need to revise the mandate or organization of the ESRB to better answer the current challenges and changes in the operating environment. The ESRB General Board has established a High-Level Group on the ESRB Review.

The High-Level Group will identify what kind of adjustments either to the mission or the framework of the ESRB would be required and will provide its insights to the EU co-legislators. The group has four members, and I have the honour of chairing it. One of the key areas which the group will be discussing is access to data.

Dear Colleagues,

Let me now turn to Finland as a case study. The ECB´s decision to cut its policy rates is welcome news for the Finnish economy, which has been struggling particularly since the energy shock and inflation spike that materialized after the start of Russia´s illegal war in Ukraine.

The Finnish housing market has been hit hard and the fall in house prices has been significant. The decline in construction activity is one of the reasons why Finland´s economy entered a recession in the latter part of last year.

As any reader of economic history knows, large disruptions in housing and other real estate markets have often led to severe financial crises. Finland in the late 1980s and early 1990s was a case in point – a dark memory that we should not forget, but certainly one that we should learn from. You can no doubt recall other examples around the world, from the Tulip mania to the global financial crisis.

So far, this time has been somewhat different, however. We have avoided such a crisis. Most Finnish indebted households have been able to service their loans, although many have been forced to reduce their consumption of goods and services. The problems in the construction sector have, fortunately, not spread widely to other sectors. Banks have even improved their profitability and capitalization, thanks to their growing net interest income.

More generally, financial systems throughout the world have remained remarkably resilient in the last few years – despite being hit by the pandemic, the spike in inflation, rapid interest rate increases and the deposit runs in regional American banks. The strengthened resilience is a testament to the profound regulatory and supervisory reforms after the global financial crisis, as well as to the better readiness of policymakers to take bold, timely and exceptional policy actions in times of crisis.

We expect that the systemic risks and vulnerabilities in Finland´s real estate market will start to ease this year, assuming that interest rates fall and the economy starts to recover as projected.

As we – the Bank of Finland – stated in our annual financial stability assessment, published in May, we are fully aware that the deterioration in the international security environment exposes Finnish and other western financial systems to shocks and widespread disruptions. For instance, there is a heightened risk that the financial market infrastructure and financial institutions could face more frequent and severe cyberattacks and hybrid interference.

In response to this, Finnish financial institutions have improved their continuity planning and contingency preparations. The national emergency account system established in Finland two years ago, in turn, ensures that critical banking and daily payment services would be available to the public even in times of severe disruption.

The short-term economic outlook for the euro area and Finland is now somewhat brighter than projected just a while ago. However, our long term growth prospects look rather weak, unless we can manage to find new sources of growth. That goes for all of Europe, too.

As documented by Ian Goldin and others, the growth rate of labour productivity in the OECD economies between the 1970s and the 1990s was around 2%. In the current century, it has fallen to 1%.

The gap between Europe and the US has been widening, especially since the pandemic. The discrepancy between post-pandemic developments in productivity is, however, exaggerated if we only look at productivity per person. This is because the pandemic caused a very large adjustment in the number of people employed in the United States, while in Europe, thanks to different job retention schemes, jobs were preserved – but hours worked fell abruptly.

In other words, average hours worked decreased dramatically in Europe, but much less in the US. Consequently, productivity per person looks substantially weaker in Europe and the euro area than in the US.

But still, even if we compare productivity per hour, Europe's performance is much weaker than that in the United States. Between the fourth quarter of 2019 and the fourth quarter of 2023, labour productivity per hour worked increased by 0.6% in the euro area vs. 6% in the US. The productivity gap has widened mainly since mid-2022, when euro area productivity growth was depressed by the energy shock. Slower growth in euro area labour productivity is broad based across sectors, within manufacturing and services alike, rather than driven by sectoral re-allocation.

While different labour market dynamics and different shocks – or at least a different magnitude of shocks – can explain the divergence of productivity growth in Europe from that in the US in the past few years, structural factors play a significant role in explaining the underlying differences between Europe and the US. This goes back to well before the pandemic.

The list of structural factors behind to the euro area's poor productivity performance is, unfortunately, rather long. The euro area lags behind the United States particularly in R&D, technology adoption and innovation. ICT and professional services stand out as the sectors with the weakest relative productivity growth in the past few decades.

Educational attainment is higher in the US on average, and the regulatory environment there is more conducive to business dynamism.

Finland has had its own challenges. Productivity growth has been very slow or non-existent for the past 10-15 years. This is the result of a unique combination of cyclical and structural shocks – and the Finnish economy's inability to adjust sufficiently smoothly.

Europe needs more productivity growth, not least because its populations are ageing, green investments require funding, public debts and deficits are large and defence expenditures need to be raised. In Finland, productivity growth is also being curtailed by the fact that the average level of educational attainment among younger age cohorts has not advanced recently.

The question of how productivity growth can be boosted is therefore a key challenge for the economics profession. While waiting for your research let me reflect.

Policies aimed at improving access to finance, such as further progress with the capital markets union, and the removal of existing barriers to the provision of services across countries could have a long-lasting impact in supporting productivity growth in the euro area. Giving fresh impetus to the EU's capital markets union by relaunching it as an investment and financing union could be one of the low hanging but high producing fruit.

This links to technology. Some of us may have very high expectations concerning the potential of generative artificial intelligence (AI) for boosting productivity and economic growth. On the other hand, some, like Daron Acemoglu (recall Robert Gordon), are less optimistic. In any event, it does appear quite probable, or at least possible, that the spread of generative AI is going to have profound ramifications for labour markets, businesses and societies at large.

Increasing attention has been given to the potential effects of AI on the financial system and financial stability. In his brilliant keynote speech yesterday, Professor Danielsson warned us how overreliance on autonomous AI systems could pose risks to the integrity and stability of the global financial system. I share his concern.

Central banks need to keep pace with developments in emerging technologies and the data economy. At the Bank of Finland, we have for quite some time already been using machine learning algorithms in several core analysis functions, such as nowcasting, or short-term GDP forecasting. The same goes for payment and settlement system simulations and financial stability analysis. Together with the Finnish Financial Supervisory Authority – the FIN-FSA – we recently established a cross-organizational centre of excellence in advanced data science. Its nicely self-confident name is ACE, the Analytics Center of Excellence.

Dear Friends,

Let me conclude. This weekend, EU citizens will vote in the European parliamentary elections. Many crucial issues are at stake in these elections.

First and foremost is European unity in the face of Russia´s threat and, more generally, in a world of heightened geopolitical challenges. Our support to Ukraine must be unwavering, and we must work on several fronts to enhance European security. We must also continue our fight against climate change.

Second, strengthening the EU economy is of the utmost importance. Only a strong economy can bring sustainable prosperity, security and stability. Maintaining price stability is the central banks' best contribution to enhancing a predictable and conducive environment for the long-term investments needed for digitalisation and the greening of our economies.

Europe's weak productivity performance calls for raising the level of ambition of the next Commission. There are no shortcuts. In addition to R&D, we must foster reforms to support productivity growth, including policies improving access to finance and removing barriers services across countries. It is clear that the recent and future developments in cutting-edge research and innovations, including AI, will play a key role in the pursuit of these goals.

Thus, it is no time for small talk, but taking big-time action for European unity and reform – what a meaningful challenge!

Thank you for your kind attention!