

# Olli Rehn: Europe in search of growth and productivity in the shadow of geopolitics

Speech by Mr Olli Rehn, Governor of the Bank of Finland, at the Peterson Institute for International Economics, Washington DC, 22 October 2024.

\* \* \*

## *[Presentation](#) accompanying the speech*

Ladies and Gentlemen, Dear Friends,

Let me begin by thanking the Peterson Institute for inviting me to speak at this year's Macro Week. It is a great honor to share my views with such a distinguished audience.

I have followed the Institute since nearly its inception, as Fred Bergsten's book was part of our coursework when I was studying economics and international relations in Minnesota. That was in the fall of 1982, a remarkable time in U.S. economic and monetary history, as Paul Volcker's disinflationary measures were simultaneously reducing both inflation and employment—a reality felt on the streets of St. Paul and Minneapolis.

I must admit, Volcker was not especially popular among us students at the liberal-leaning Macalester College, though he was certainly respected for his consistency and persistence, at least among the economics majors. In hindsight, his actions had historic significance, not just for monetary policy, but also for great-power relations—they helped restore the economic foundations of U.S. global strategic influence.

As for me, I could say—if it didn't show a serious lack of self-irony—that this was a formative experience for a future central banker, though at the time, I had no inkling that I would one day enter this field. In every central banker, there is a little Paul Volcker. — I shall return to the lessons of Volcker's disinflation later, in the context of Europe's recent experiences.

## **Slide 2. Roadmap of today's talk**

You can see the roadmap of today's talk on this slide. I will first of present my thoughts on the ongoing strategy review of the European Central Bank (ECB), which is due for completion in 2025. Second, I will focus on the implications of the recent rise in both geopolitical and geoeconomic fragmentation. Third and finally, I will discuss what in my view is the Achilles heel of Europe: weak productivity growth.

## **Slide 3. Three periods of euro area inflation**

To provide context for the ongoing ECB strategy review, let's take a look at the history of inflation in the euro area over the last quarter of century, dividing it into three distinct periods.

First, during the final years of the Great Moderation from 1999 to 2009, inflation averaged around 2%. Then, in the post-financial crisis period until 2021, inflation was exceptionally low, averaging just above 1%. After 2021, as we know, inflation surged and has averaged over 5%. Each of these periods has been characterized by different drivers of inflation (or deflation!).

When we at the ECB Governing Council last reviewed our monetary policy strategy, in July 2021, we had witnessed nearly a decade of low inflation. But we were actually on the brink of a period of dramatically accelerating inflation. The Federal Reserve faced a similar situation, as the Federal Open Market Committee reviewed their monetary policy strategy in August 2020. The Fed then adopted flexible average inflation targeting, designed to address persistently low inflation.

#### **Slide 4. The perceived de facto ceiling under the old target pushes inflation expectations clearly below 2%**

Before the ECB's 2021 review, the price stability definition ('below but close to 2%') was perceived as asymmetric, as seen in this graph.

This perception is supported by several studies by the Bank of Finland and ECB staff. The asymmetry set a virtual 2% ceiling for inflation, thus lowering the de facto inflation target and leading to asymmetric policy responses and preferences.<sup>1</sup>

#### **Slide 5. The ECB's current monetary policy strategy: a symmetric 2% inflation target over the medium term**

Hence, by far the most consequential decision in the ECB's 2021 strategy review was to establish a symmetric inflation target of 2% over the medium term. The symmetry implies that both negative and positive deviations from the target are equally undesirable. Another key element of the strategy is the medium-term orientation for reaching the target.

Empirical evidence shows that the ECB's revised symmetric inflation target has been effective in anchoring long-term inflation expectations firmly to the 2% inflation target, despite the turbulence of recent years.

In the 2021 strategy review, most of our work focused quite naturally on improving our policymaking in a '*lowflation*' environment. Now, over three years and three crises later, we are re-assessing how well the revised strategy has performed in a high inflation environment. Most importantly, we need to consider how to further develop our strategy in the light of an emerging new – or perhaps old or recycled – normal.

#### **Slide 6. Inflation is stabilizing to our symmetric 2% target – which has served us well**

Right after its introduction in 2021, the ECB's new monetary policy strategy was put to the test in an environment it was not specifically designed for: a series of supply shocks and rapidly accelerating inflation.

The supply shocks were caused first by the COVID-19 pandemic and then by Russia's unjustified and brutal war in Ukraine that led to a sharp increase in energy prices. These supply factors contributed to the surge of inflation to a peak of 10.6% in October 2022. Inflation averaged 8.4% in 2022 and 5.5% in 2023, as measured by the Harmonized Index of Consumer Prices (HICP), shown on the left-hand graph. We've come a long way from there: in September 2024, HICP inflation stood at 1.7%.

Besides driving the already high inflation rate, the energy crisis caused a rocketing rise in the energy import bill for Europeans, increasing it by around 400 billion euros, equal to 3%–4% of GDP. Stagflation, i.e. the combination of stagnation and high inflation, became a serious threat scenario, presenting a major dilemma for monetary policy.

After a period of deliberation in 2022 from March until June, the ECB began raising interest rates. We discontinued quantitative easing (QE) and increased policy rates rapidly by a total of 450 basis points between July 2022 and September 2023, bringing the deposit rate, our main policy rate, from -0.5% to 4%. In line with our revised strategy, we intended to tame inflation over the medium term by preventing high inflation from leading to elevated inflation expectations and potentially to a wage-price spiral. In my view, this goal has largely been achieved.

Some argue that we should have acted sooner. I can say that many of us policymakers were indeed ready to raise rates earlier due to soaring inflation. However, Russia's invasion of Ukraine in February 2022 reintroduced the era of brutal geopolitics and created a massive cloud of stagflationary uncertainty over Europe's economy. While the ramifications were felt globally, and still are, the impact was more severe for Europe than, for example, the United States. This is something to keep in mind in all post-mortems of the recent poly-crisis years.

Looking at the latest policy decisions, progress in lowering inflation has enabled us to make three 25 basis-point cuts to interest rates since June 2024. The most recent cut was unanimously decided last Thursday, as we now have greater confidence that inflation is converging towards 2% on a sustained basis. Disinflation in the euro area is well on track.

All in all, a soft landing seems plausible in the euro area. However, growth is expected to remain sluggish, as shown in the right-hand graph. The growth outlook has weakened quite clearly in the past few months, which could also increase disinflationary pressures.

Based on the current outlook, and as our rates still are at the restrictive territory, the direction of rate changes is clear. The speed and scope of rate cuts will depend on our overall assessment of the trend in three variables: the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission.

## **Slide 7. Reflections on the ECB's next strategy review in 2025**

Based on the experience of recent years, the symmetric, medium-term 2% inflation target has served us well. It has provided a clear anchor and enough pre-calibrated and meaningful flexibility in terms of both the timing and instruments of policy. We have not had to take the drastically contractionary policy actions that the old target might have

implied. And we didn't need to show Volckerian stubbornness, with all respect to him, thanks to the fact that inflation expectations remained well-anchored.

Thus, in my view, the inflation target itself does not need to be revisited now. As the saying goes, don't fix it if it ain't broke. However, we do need a deeper understanding of inflation dynamics and the secular trends that are transforming the operational environment of monetary policy, such as geopolitical fragmentation, climate change, labor market transition and other structural drivers of the natural rate of interest.

Geopolitical tensions have risen substantially with Russia's illegal war in Ukraine, the tragic war in the Middle East, and China's strategic aims, both technological and military. Trade wars, protectionism and geoeconomic fragmentation are the byproducts of these tensions, and so are the diversion and relocation of global value chains.

Key questions for central bankers are, how significant are these developments, and do they have implications for the level of the long-term real natural rate of interest, or the equilibrium interest rate,  $r^*$ ?

To answer these questions, it is useful to look at whether production is being reshored or transferred back home at substantial levels. In other words, is globalization indeed reversing?

### **Slide 8. Geopolitics is shaping the operating environment – along with other secular trends**

Yes, we are witnessing signs of trade fragmentation. Given the steep rise in trade barriers and protectionism, the ramifications to the world economy, not least the EMDEs, should not be underestimated. But so far, no fully-fledged reversal of economic globalization has taken place.

What we are mostly seeing is the lengthening of global value chains. Even if **direct trade** between China and the West is in modest decline, **Chinese value-added** imported by the U.S. and EU have not diminished – our BOFIT staff analysis indicates that, in between 2018 and 2023, Chinese value added remained stable in US manufacturing imports and slightly increased in Europe – as shown in the left-hand graph. It seems that value chains have simply been rerouted via connector countries, such as Mexico and Vietnam.

Smaller countries like Finland and the other Nordics have greatly benefited from deepening economic integration. Multilateral trading system has been a win-win and a key building block of the strategic community of liberal democracies. Economic cooperation with the United States remains crucial for this achievement and alliance, even if this fact has not been overly prevalent in the U.S. presidential elections. Trade wars would only damage this bond. Suffice it to say that we Europeans are forced to pre-emptively prepare for different options.

Thanks to Finland's accession to NATO, our ties with the US and our trade partnership has strengthened, also in strategic areas (right-hand graph). Notable cases are cruise ships and tech products exported to the US, and on the imports side, the new American F-35 fighter jets that will replace soon our cherished but aging F-18 Hornets.

The biggest increase in Finland's trade with the US has come from trade in digital products and IT services. In my view, this underlines the substantial mutual benefits of this economic partnership.

### **Slide 9. Estimates of the natural rate of interest in the euro area**

The precise implications of geoeconomic fragmentation for inflation, growth and productivity, and therefore for monetary policy, warrant careful consideration in our ongoing strategy review.

A key question is the level of the long-term real natural rate of interest,  $r^*$  or the equilibrium interest rate. R-star is a most pertinent analytical framework for thinking about the economy and monetary policy, even though it is not truly viable as a concrete policymaking tool.

Some argue that the natural rate is rising due to significant investment needs for the green transition, artificial intelligence and defense spending. Meanwhile, others believe it is declining due to weak productivity growth, aging populations and geoeconomic fragmentation. The true trajectory of the natural rate remains unclear and requires plenty of further and deeper analysis and continuous research.

Estimates of  $r^*$  for the euro area are currently slightly above zero, or broadly between 0 and 1, as shown in this graph. At the Bank of Finland, we also regularly examine the evolution of natural rate, of course acknowledging the significant uncertainty associated with estimating  $r^*$ . Our researchers currently estimate the euro area natural rate to be in the range of 0.2-0.8%, which is in the same ballpark as the estimates in this graph and somewhat above that of the New York Fed with its broadly recognized Holston-Laubach-Williams model.<sup>2</sup>

### **Slide 10. Productivity growth is Europe's Achilles heel – we need decisive actions**

Let me finally turn to the marked slowdown in productivity growth, which is the real Achilles' heel of Europe. This is an issue that is closely linked to the natural rate and monetary policy, but also to the longer-term economic success of Europe (and other nations for that matter).

Europe's long-lasting productivity gap to the U.S. has widened further in the past few years, as shown in the left-hand graph. A key reason for this is the energy shock resulting from Russia's war in Ukraine, as it adversely affects competitiveness specifically in the euro area – unlike past oil shocks that tended to hit all firms globally. The right-hand graph shows that the producer prices for energy rose much more in the euro area than in the US, but they have also remained higher.

In Finland, we have adjusted to the loss of Russian energy imports by increasing domestic production of renewable and nuclear power. Thus, energy prices did not increase so drastically in Finland as in some other countries and have indeed already returned to their pre-pandemic level.

A major reason for Europe's slow productivity growth in recent years is **weak investment**, driven by the uncertainty from Russia's war in Ukraine and the energy crisis, and possibly tight financial conditions.

As to the determinants of productive investment, the distinction between structural and cyclical is never crystal clear – it's rather a line drawn in water. It is true that the current clouds of both brutal geopolitics and trans-Atlantic and intra-European uncertainty are weighing on the European economy in the form of confidence-damaging effects.

Still, if I may paraphrase a certain giant of economics: "In the long run we are all retired. But in the meantime, we need more investment."

In other words, even though Europe's longer-term growth and competitiveness challenges cannot be solved by monetary policy tools, we know that investment is driven by many factors, not least by aggregate demand, which is obviously affected by financial conditions. Thus, in the shadow of recent supply shocks and current slow growth, an easing in financial conditions should help avoiding scarring effects in investment that is needed to increase longer-term productivity<sup>3</sup>.

The need to pursue stronger productivity growth on all fronts is the key message in the recent report on EU competitiveness by ex-President of the ECB, Mario Draghi. The Draghi report is a clear-eyed and even brutal diagnosis of Europe's weak growth and weak competitiveness. It makes important proposals for closing the innovation gap and combining climate goals with industrial competitiveness, as well as enhancing security by pooling defense capacities in the EU.

Likewise, Draghi calls for cutting the red tape and speeding up structural reforms at both national and EU levels. We must support better diffusion of new technologies, improve access to finance and remove existing barriers to services across countries. Cutting-edge research and innovation, including AI, will play a key role in the pursuit of these goals.

## **Slide 11. Conclusions**

Let me conclude. Many crucial issues for Europe are at stake now, and they also matter for the United States, Europe's closest ally and partner.

First and foremost is unity and determination in the face of Russia's imperialist aggression. This is an existential issue not only for European security but for the whole free world. Our support to Ukraine must remain unwavering, and we must work with all our partners to strengthen international security and cooperation.

Second, the rise in geopolitical tensions is contributing to an increasingly uncertain and volatile global environment and has significant implications for economic policy in Europe—and beyond. The changing geopolitical landscape, along with other long-term trends, shapes the new normal that we must consider when we develop our monetary policy strategy.

Finally, reinforcing the structural foundations of the European economy – i.e. productivity growth and industrial competitiveness – is of paramount importance. While we face many challenges, with determined national action and EU-wide cooperation Europe can revitalize its productivity growth and lay a solid basis for sustainable growth and employment.

A key part of this effort will be fostering mutually beneficial partnerships with like-minded countries, especially the United States.

Thank you for your attention! I am looking forward to your questions and what will no doubt be an interesting discussion.

## References

Haavio, M., Heikkinen, J., Jalasjoki, P., Kilponen, J., Paloviita, M. and Vänni, I. (2024), [Reading between the lines: Uncovering asymmetry in the central bank loss function](#), Bank of Finland Research Discussion Papers 6/2024 and SUERF Policy Brief No. 992.

Paloviita, M., Haavio, M., Jalasjoki, P. and Kilponen, J. (2021). What Does "Below, But Close To, Two Percent" Mean? Assessing the ECB's Reaction Function with Real Time Data. In: *International Journal of Central Banking* 17.2, pp. 125–169.

Rostagno, M., Altavilla, C., Carboni, G., Lemke, W., Motto, R., Guilhem, A. and Yiangou, J. (2021). *Monetary Policy in Times of Crisis: A Tale of Two Decades of the European Central Bank*. Oxford University Press.

---

<sup>1</sup> See Rostagno et al. (2021), Paloviita et al. (2021) and Haavio et al. (2024).

<sup>2</sup> Kortelainen and Vilmi: *Recent insights into  $r^*$ : an analysis using the modified HLW model*, forthcoming.

<sup>3</sup> Fornaro and Martin Wolf, The scars of supply shocks: implications for monetary policy. Science Direct 2023. Link: <https://www.sciencedirect.com/science/article/pii/S0304393223000417?via%3Dihub>