Olli Rehn: The European economy under pressure - how is geopolitics impacting trade, finance and competitiveness?

Remarks by Mr Olli Rehn, Governor of the Bank of Finland, at the annual meeting of the EU Heads of Mission, Bank of Finland, Helsinki, 2 December 2024.

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Accompanying presentation of the speech

Your Excellencies, Distinguished Guests, Ladies and Gentlemen,

Let me warmly welcome you to this traditional lunch event at the Bank of Finland. It is an honour and pleasure to meet with you today, at the start of the week that culminates to the Finnish Independence Day. As EU Heads of Mission, your role is pivotal in helping shape our collective future, and I am grateful for the opportunity to engage with you.

Today, I would like to share my views on how the current geopolitical climate is influencing our economy. I will focus on three key channels. First, the impact of geopolitics on trade. Second, on finance, and hence monetary policy. And finally, on competitiveness and productivity.

The underlying message you may detect throughout my speech is that we need unity and agility in Europe to stay relevant in the world – a world characterised by heightened geopolitical tensions.

Slide 2. Global geopolitical tensions remain elevated

Currently, we find ourselves amid a tense and dangerous geopolitical landscape, marked by multiple simultaneous conflicts and crises – a polycrisis – which have ramifications on Europe and beyond.

Global geopolitical tensions remain elevated, as shown by the Geopolitical Risk Index – and as we all know from our daily news flow.

Slide 3. Geopolitics is overshadowing economic developments

Looking at the global landscape, the rise in geopolitical tensions is especially due to Russia's illegal and brutal war in Ukraine, the conflicts in the Middle East, and China's strategic ambitions as a technological and military big power. These developments have profound implications for Europe, including for our economic outlook and policy.

As we move forward, the key to successfully navigating these global challenges lies in the effective cooperation between the United States and the European Union, together with our international partners in the global geopolitical arena. As autocracies like Russia and China are forcibly challenging the rules-based international order, we need to defend the value system of liberal democracy against these systemic rivals that advocate alternative governance models. It is therefore essential that we prioritize cooperation, dialogue and diplomacy.

Given the multitude of conflicts – both large and small – around the world, the last thing we would need is another trade war, particularly between the allies, the European Union and the United States. The incoming US administration comes to town with a hawkish trade policy. Maintaining a stable trade relationship between the EU and the US – for sure not easy – should be a top priority for policymakers. Seldom have trade and security policies been as interlinked as today in Europe.

Simultaneously, we must prepare for possibly turbulent trade relations with the US. Europe cannot face such a scenario unprepared, as in 2018. This calls for agility and clear strategic thinking in our decision-making processes. What is also vital during these turbulent times, is the unity of Europe. The European Commission has both the chance and duty to demonstrate strong leadership within Europe now. This unity is supported by the Community method in the field of trade policy.

While messages on future US trade policy somewhat fluctuate, we need to prepare ourselves for a situation where the EU is threatened by higher tariffs and other trade measures from the US. Clearly, a trade conflict harms the economy. In a cycle of retaliation, no one is a winner. Hence, a negotiated solution is preferable, but evidently our negotiation position needs to be reinforced by credible potential countermeasures.

In this connection, it is worth noting that it is almost certain that European imports of American weapons and LNG continue to rise in the coming years, as the European countries increase their defence spending and bolster their energy security. This can be one part of a positive solution for the potential trade negotiations, though Europe must avoid again creating unsustainable dependencies.

The war in Ukraine has made it necessary to strengthen the EU as a strategic entity, although the transatlantic axis remains an anchor stability for Europe. The economic sanctions by the EU and the US have weakened Russia's capacity to achieve its imperial goals in Ukraine, but we must not underestimate its continued capacity to wage the war. Consequently, we experience critical weeks and months of uncertainty. And we must prepare our economies and societies to cope with the gathering storm during this winter.

Slide 4. EU free trade agreements in 2024: status report

Due to the prevailing uncertainty about the US trade policy, Europe should now invest ever more effort in further developing trade relations with the rest of the world, not least with the emerging and developing economies of the so-called Global South.

The starting point is solid: we have free trade agreements (FTAs) in place with 74 countries worldwide, covering over 44% of our external trade. These countries include major economies, such as Japan, South Korea and Canada. These FTAs provide market access to businesses, reduce tariffs and promote trade relationships. Moreover, FTAs with Australia, India ja Indonesia are currently being negotiated.

Right now, we have the choice to conclude the ratification of the Mercosur FTA, which has been pending for years. This should happen before countries like Brazil turn to China, which would not be in our interest. Latin American democracies are natural partners for Europe, and trade agreements that can strengthen this partnership should be seen as a strategic priority and a geopolitical necessity. The credibility of the EU as a negotiating partners is also at stake.

Globally, trade is in transformation. Protectionism, trade wars and geoeconomic fragmentation in general are the by-products of geopolitical tensions. The pandemic further accelerated the diversion of global supply chains. These developments are likely to increase economic shocks and inflation volatility, and so these are critical issues that central bankers must closely monitor.

We are indeed witnessing some signs of trade fragmentation, primarily in two significant ways. Firstly, bilateral trade between the US and China has diminished and some supply chains have been relocated from China to Southeast Asia, Mexico and emerging economies in Europe, for instance. These shifts aim to mitigate supply chain disruption risks and avoid import tariffs or export restrictions. Secondly, Russia's war in Ukraine has effectively isolated Russia from the European Union, the G7 countries and their allies. This has resulted in a dramatic reduction in trade between the EU and Russia since February 2022.

Furthermore, China and India are challenging some measures adopted by the EU and the US, like the Carbon Border Adjustment Mechanism, the Deforestation Act and the US IRA subsidies as "unilateral trade measures" and barriers to trade.

Slide 5. Domestic value added has decreased in the EU

In this complex environment, it is useful to examine whether production is being reshored transferred back home at significant levels. In other words, is globalization truly reversing?

Our staff analysis of the origins of value added in manufacturing indicates that in the United States, the share of domestically produced value added increased between 2018 and 2023. Conversely, in the EU, there was a decrease in domestic value added. This suggests some reshoring dynamics in the US and the opposite in Europe. The fact that domestic value added has decreased in the EU may reflect our industry's muted competitiveness, which we will discuss later on.

Slide 6. Chinese value added has increased in the EU and remains unchanged in the US

Our findings also highlight the challenges of decoupling or de-risking from China, due to the deeply integrated nature of global production networks. Even though direct trade between China and the United States shows signs of a modest decline, the share of Chinese value added in US manufacturing imports remained stable during the period examined. It appears that value chains are simply being re-routed through connector countries like Mexico and Vietnam.

In the European Union, Chinese value added in manufacturing has in fact increased since 2018. While complete decoupling from China is virtually impossible, this clearly emphasizes the need for Europe for a stronger de-risking strategy.

While there is some evidence of shifting global trade flows, nearshoring and reshoring, there is currently no comprehensive indication that globalization is reversing. Obviously, this may change, perhaps even relatively soon, if the incoming Trump administration intends to keep its promises of significantly higher tariffs. In any case, the implications of these trends for growth, productivity and the monetary policy environment remain uncertain and warrant careful consideration.

Slide 7. Monetary policy has been rather effective in reducing inflation

Geopolitical tensions are not only impacting global trade flows but also finance, and hence monetary policy. Recent years have served as a testing ground for how a geopolitical polycrisis impacts inflation dynamics and the corresponding monetary policy responses. Overall, the European Central Bank's monetary policy has been rather effective in bringing inflation under control. Interest rate hikes in 2022–2023 were necessary in anchoring inflation expectations at the 2% target level.

While inflation has declined significantly and is now stabilizing to our target, the euro area has managed to sustain positive growth, and employment levels have remained robust. However, growth remains sluggish, and the economic outlook has deteriorated in recent months.

Given the current inflation and growth outlook, and considering that monetary policy remains restrictive, the trajectory for interest rates is clear: downward. The pace and scale of future rate cuts will depend on the ECB Governing Council's comprehensive assessment of three key factors: the headline inflation rate, the dynamics of underlying inflation, and the effectiveness of monetary policy transmission.

Provided that incoming data and new macroeconomic projections confirm the current inflation and growth outlook, there is reason to continue rate cuts at the December meeting of the Governing Council.

Slide 8. Reflections on the ECB's strategy review in 2025

Looking beyond December, the ECB's ongoing strategy review, which is due for completion in 2025, provides an opportunity to analyse the changing geopolitical landscape. While there is no need to change the symmetric inflation target of 2% over the medium term – it has worked well – we need to better understand inflation dynamics going forward.

Elevated geopolitical tensions can lead to financial market volatility and impact the pricing of risk and the cost of financing. Global trends are reflected in the level of the long-term natural rate of interest, r*; that is, the equilibrium rate. Some argue it is rising due to significant investment needs for the green transition, artificial intelligence and defence spending. Meanwhile, others believe the natural rate is declining due to weak productivity growth, ageing populations and geoeconomic fragmentation. The true trajectory of the natural rate remains unclear and requires deeper analysis and continued research.

Slide 9. Market forces expect the ECB to continue to rate cuts

Current market expectations, illustrated on this slide, are that the ECB policy rate will fall slightly below 2% by summer 2025.

There has been some discussion lately about a return to forward guidance. Such discussion is natural in the context of the strategy review. In my view, forward guidance should remain part of our toolbox, and it works best when we need to address the well-known problems of the effective/zero lower bound and excessively low inflation.

But in the prevailing conditions of high uncertainty and imperfect information, it is better to avoid such forward guidance that ties policymakers' hands. That said, as we are gradually moving from the backward-looking into forward-looking approach, as Philip Lane explained in the FT this morning, directional guidance makes sense – as long as we remember to emphasise that decision-making is indeed dependent on economic and financial data and on the analysis of the growth and inflation dynamics and the long-term trends in them.

So, the direction for now is clear and, in my view, we will be moving from the restrictive territory towards a neutral level of policy rates in the course of the coming springwinter. And as we all (should) know, in Finland this can mean anything between January and June.

Slide 10. Europe must find ways to increase productivity

After looking at the impact of geopolitics on trade and finance, we should turn our glance to the Achilles heel of Europe: the marked slowdown in our productivity growth. While the entire manufacturing sector in Europe seems to be characterized by prolonged underperformance, which points to structural problems, the current geopolitical landscape is putting additional pressure on industrial competitiveness.

In that context, European industry must strengthen its technological capabilities. Cutting-edge research and innovation, and of course investment, particularly in areas like AI, will be crucial for maintaining Europe's relevance on the global stage. And we need to address the price of energy as a key hindrance to Europe's competitiveness. Unlike the US, Europe has no abundant fossil fuel supplies, so there is no other strategy for increasing our energy security than decarbonization.

Global uncertainty and geopolitical challenges demand agile decision-making. We need to streamline decision-making processes and reduce bureaucratic red tape, which will empower us to act more decisively. This would also help improve Europe's industrial competitiveness and productivity growth, as underlined in the Draghi report.

Slide 11 Summing up

Ladies and Gentlemen, Dear Friends,

In conclusion, the rise in geopolitical tensions is contributing to an increasingly uncertain and volatile global environment. This has significant implications for economic policy in Europe and beyond.

First, a new trade war would most definitely be unwelcome amid today's geopolitical rivalries – especially among allies. If a trade war were to start, Europe must not be unprepared for it, as it was in 2018.

The evolving geopolitical landscape, along with other long-term trends, will shape global financial markets and the monetary policy environment, and we must carefully consider all these shifts as we review and develop the ECB's monetary policy strategy.

Moreover, reinforcing the structural foundations of the European economy – productivity growth and industrial competitiveness – is paramount to maintaining a key role for Europe in the future.

The Eurosystem will, within its mandate, continue to act as an anchor for economic and financial stability in this landscape of great challenges. No one should doubt that we will shoulder this responsibility in full.

Thank you for your attention! I am looking forward to your questions and to what promises to be an engaging discussion.