Olli Rehn: Economic outlook and monetary policy – a European perspective

Talk by Mr Olli Rehn, Governor of the Bank of Finland, at the Council on Foreign Relations, New York City, 17 April 2019.

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Ladies and Gentlemen,

Good morning to everybody. Many thanks for the invitation to give a talk at the Council on Foreign Relations, which does immensely valuable work to keep the flame of rules-based multilateralism and the liberal international order alive, in a rather challenging political environment. Hence it is a great honor and pleasure to address and discuss with you today.

In my opening remarks I will focus on the economic outlook and monetary policy in Europe. After that I am glad to take questions and comments.

Let us recall what has happened since we tamed the crisis. During the euro area recovery since 2013, over 10 million new jobs have been created, and unemployment has fallen from its peak of over 12 percent to below 8 percent. The banking sector is now more resilient, the amount of non-performing loans in banks have decreased significantly, and lending to households and non-financial corporations have increased. The ECB's accommodative monetary policy has been very important in facilitating and supporting the recovery.

Following the economic recovery and the then positive economic outlook, the discussion on monetary policy normalization began to proceed in the euro area in 2018. In June 2018, the ECB Governing Council expected to end the net purchases of monetary policy at the end of 2018. At that time, the decision was still conditional and dependent on inflation.

At its meeting in December 2018, the Governing Council of the ECB decided to end net purchases in the asset purchase program at the end of the year. At the same time, the Governing Council announced that it will continue to invest the maturing bonds fully for an extended period of time after the ECB Governing Council has raised the ECB's key interest rates, and in any case as long as it is necessary to maintain a favorable liquidity situation and accommodative monetary policy that supports growth and converges inflation to the ECB's goal of close but below 2 percent. The policy rates were expected to remain at their current levels through the summer of 2019.

Since then, the incoming data during the first months of 2019 have confirmed that global economic activity has slowed down, which is now felt also in the euro area. Prevailing uncertainty, stemming from the US-China trade tensions, slowdown of growth in China and Europe's internal problems, have all weakened the outlook for the economy. The growth forecasts for the current year have broadly been revised downwards, also for the euro area by the ECB staff in March. While some indicators hint for stabilization, much of the recent data continue to be weak, especially for the manufacturing sector. There are both country- and sector-specific factors, and the impact of these factors is turning out to be somewhat longer-lasting, slowing down growth momentum during the current year.

The slowdown of growth has been accompanied with moderating inflation. In March 2019, the ECB staff forecasted inflation to slow down to 1.2 percent in 2019 and then reaching 1.6 percent by 2021. Consistently with the weaker outlook, the market-based inflation expectations have declined.

As a consequence of the slowdown, (almost) all major central banks have had to put monetary policy normalisation on hold and instead to maintain an accommodative policy stance. This holds true for the ECB as well.

On the back of the weakened economic outlook, the ECB Governing Council in March and again last week, on April 10th, took a number of decisions in the pursuit of its price stability objective. First, a commitment to keep the key policy interest rates at their present low levels at least until the end of 2019. Second, a commitment to continue reinvesting maturing securities under the asset purchase programme for an extended period of time, beyond the first rate increase – thus we apply chained forward guidance on these two policy instruments. And third, launching a new series of targeted longer-term refinancing operations (TLTRO-III), starting in September 2019.

Hence, the ECB Governing Council maintains an ample degree of monetary accommodation to support the economic expansion. Significant monetary policy stimulus is indeed being provided by our forward guidance on the key ECB interest rates, reinvestments by a sizable stock of acquired assets, and the new series of targeted long-term refinancing operations.

Moreover, as President Draghi said, the Governing Council stands ready to adjust all of its instruments, as appropriate, so that inflation converges to our aim, which is below but close to 2% in a sustained manner. It is worth noting that our inflation aim does not imply a ceiling at 2%, since inflation can deviate from our target in both directions.

At the same time, it needs to be asked whether a more even balance between monetary and fiscal policy stances would be desirable in order to sustain the growth momentum in the current conjuncture. In our view it should be underlined that, in order to reap the full benefits from the ECB's monetary policy measures, other policy areas must contribute more decisively to raise the growth potential and reduce vulnerabilities. For the longer term, implementation of structural reforms is key to boost euro area productivity and growth potential. Regarding fiscal policies, the mildly expansionary euro area fiscal stance today and the operation of automatic stabilisers are already providing support to economic activity.

If the slowdown is judged more stubborn, any further fiscal easing should be undertaken within the limits of debt sustainability and be differentiated according to fiscal space available. In other words, while countries with elevated public debt levels should focus on consistent consolidation of public finances, those with available fiscal space could use it to increase growth-enhancing public investment. In this way, one would enable a more balanced macroeconomic policy mix. Applying the already worn saying, monetary policy should indeed not be the only active player in town.

Finally, a word on the longer-term. The ECB – much like other central banks – must operate in an environment where long run trends, such as population aging, lower long term interest rates, climate change and concerns about inequality, can have important societal effects. The central banking community needs to understand the implications of these phenomena to growth, employment and inflation dynamics, in order to deliver more effectively what is in their mandate. That's why we need to systematically assess how these transformations affect monetary policy strategy.

Many thanks for your attention, and I am ready to take your questions.