Olli Rehn: Global economic outlook - a European perspective

Speech by Mr Olli Rehn, Governor of the Bank of Finland, at the Federal Reserve Bank of Dallas, Dallas, 19 August 2019.

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Accompanying slides of the speech.

I would like to thank the Dallas Committee on Foreign Relations and the Federal Reserve Bank of Dallas for your kind invitation to give a talk here today. It is a great pleasure to have the chance to discuss the economy and monetary policy in such company.

I will start with some thoughts about life in a monetary union that is something that unites us, as Texas is a classic case study in the US dollar union, and my country Finland is a founding member of the European Monetary Union.[1] I will then present a European view on the near-term global economic outlook. Finally, I will discuss euro area monetary policy.

One relevant perspective on the economics of a monetary union is provided by the well-known theory of optimum currency area. This emphasizes the significance of asymmetric shocks, normally country-specific, which can cause costly adjustment problem for an individual member state when the interest rate is set for the entire currency area and the exchange rate towards the other member countries is fixed. Within currency unions, labour mobility and income transfers have been regarded as key elements for adjusting to asymmetric shocks.

Generally, an economy living on a single commodity and its refining industry, and therefore exposed to cyclical fluctuations of this particular commodity, is assumed to be particularly vulnerable to asymmetric shocks. In economics, this is often called the ‘Texas phenomenon’, since the difficulties of the oil-rich state of Texas in adjusting to the often large fluctuations in crude oil prices in the US dollar union (i.e. in the absence of a state-level Texan currency of its own) has been considered a classic example of an economy susceptible to asymmetric shocks.

It may surprise you, although it should not, but the Texas phenomenon was widely discussed in Finland in the 1990s when European Monetary Union was being developed. I am not sure how relevant the Texas phenomenon still is here, as I have understood that the Texan economy is today well diversified, with many thriving industries.

But for a small economy in a monetary union, in the presence of large asymmetric shocks, the Texas phenomenon certainly is relevant. Oil has not been found in Finland, but we do have industries that have experienced large swings in fortunes, such as the forest and electronics industries – including what was, for a period of time, the very successful mobile phone business of Nokia Corporation.

In order to adjust to the shocks to above mentioned industries, together with the global financial crisis, we eventually had to restore our cost competitiveness through an internal devaluation, as an external adjustment was no more possible. Following difficult negotiations with the trade unions and employers, the social partners agreed on a ’competitiveness pact’ in 2016. Together with some other measures, it has helped to reduce unit labour costs by 6.5% in 2014–17, and our economy has recovered from zero growth to 2-3% growth in the last years. Employment rate has increased from 68% to over 73%.

Today, the production of mobile phones does not play a major role in the Finnish economy anymore, and the role of traditional paper production has also diminished. The sustainable bio-economy has, however, given the Finnish forest industry a new lease of life. Various branches of technology-intensive industries have become more important in Finland, including healthtech, as well as various forms of cleantech.

It is a fact of life that asymmetric shocks are always a feature of a monetary union. They are one important reason to reform and improve the structures of European Monetary Union.

The euro was introduced twenty years ago in order to insulate the Single Market of the European Union from exchange-rate crises and competitive devaluations. The most difficult moments of European Monetary Union followed the Great Recession, when the European sovereign debt crisis ran wild in 2010–12. The roots of the crisis lay in the systemic weaknesses of the monetary union, which were not recognized in the first two decades of the euro in 1990–2010.

A lot has been learned from the crisis and done to strengthen European Monetary Union since then. The most important steps still to be taken concern the financial system. The European Banking Union needs to be finalised, and progress is needed in building the Capital Markets Union. At the same time, every member state of EMU should work to strengthen the structures of its economy, pursue growth-enhancing reforms and ensure the sustainability of its public finances.

Ladies and Gentlemen,

[SLIDE 2]

Let me now turn to recent developments in the global economy. We are experiencing a widespread slowdown. Growth has slowed in basically all major economic areas during the past year.

I would identify three main reasons for this subdued global growth. The first reason is trade tensions. Tariffs and other trade barriers have been raised. And even if the direct effects of the actions taken so far may be limited, they have already increased uncertainty about the future of international trade. Looking ahead, there is a risk that projectionism becomes the norm. This would be very harmful for the world economy, not to mention economic areas like Texas or Finland.

[SLIDE 3]

Trade barriers have a negative impact on investments and purchases of durable goods, in particular. They explain part of the recent stagnation in the volume of global trade. Pervasive uncertainty has hit its growth, which has fallen from +4-5% evento below zero.

Secondly, the many twists and turns of Brexit have increased uncertainty about under what terms the EU will trade with the UK in the future. This has already affected euro area trade with the UK. If a so-called hard Brexit materializes, it would certainly have a negative effect on euro area growth. For euro area exports, the UK is the second largest destination, almost as large as the United States.

In addition to the disturbances related to international trade, we can also ask whether the long upswing after the Great Recession is maturing. The United States economy is experiencing the longest period of growth in its history and seems to be enjoying almost full employment.

The third reason for the deteriorating global outlook is the slowdown in China. This has been going on for a while already and seems to be partly structural in nature. But trade tensions and vulnerabilities in China’s domestic economy have also contributed to the slowdown. Alternative estimates of China’s GDP already suggest significantly lower growth rates.

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Overall, many risks have materialized in the global economy recently. The change in the global economic outlook has also been felt on the financial markets, not least in the expected path of policy interest rates. Earlier expectations of a gradual normalization of monetary policy have recently been replaced by expectations of further policy easing, including rate cuts. Long-term interest rates have declined significantly.

The global slowdown has also been felt in the euro area. While in 2017 euro area GDP still grew by 2.4%, the economy began to cool in the second half of 2018. Current macroeconomic projections for the euro area foresee annual real GDP increasing by 1.2% in 2019.

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As in many other developed economies, recent developments in the euro area have been especially weak in manufacturing. The Purchasing Managers' Index for the manufacturing sector has declined significantly. Recently, manufacturing output has declined in Germany.

During 2018, it was thought that the headwinds for the euro area economy were mostly coming from idiosyncratic factors related, in particular, to the auto industry. In the course of this year it has become more likely that we are witnessing a more lasting deterioration.

However, all this recent gloom in international trade and manufacturing does not necessarily mean a serious slump in the euro area economy as a whole. Domestic demand has remained quite robust, supported by an accommodative monetary policy and strong labor markets.

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The unemployment rate in the euro area stood at 7.5% in June, close to an all-time low. The labor force participation rate has risen from 59% to 67%, the highest level ever recorded. Moreover, since reaching the trough of the business cycle over six years ago, euro area employment has increased by about 10.5 million persons. So, the strong labor market development is supporting domestic demand in the euro area and partly compensating for the decline in external demand.

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However, despite the stronger labour market and accelerating wages, inflationary pressures remain muted and indicators of inflation expectations have declined with the weakening economic outlook. Therefore, a significant degree of monetary stimulus continues to be necessary to ensure that financial conditions remain very favourable and to support euro area growth and domestic price pressures.

In its meeting in July 25, the ECB Governing Council communicated the need for a highly accommodative monetary policy stance for a prolonged period, as inflation rates, both realised and projected, have been persistently below levels that are in line with our aim.[2]

If the medium-term inflation outlook continues to fall short of our aim, the Governing Council is determined to act, in line with its commitment to symmetry in the inflation aim. With the symmetric approach, inflation may vary around 2% in the short-term, to reach our target in the medium term, thus supporting the anchoring of inflation expectations.

We stand ready to adjust all of our instruments, as appropriate, to make inflation converge towards its aim in a sustained manner. We are currently examining options, including ways to reinforce our forward guidance on policy rates, mitigating measures related to the negative deposit facility rate – such as the design of a tiered system for reserve remuneration – and options for the size and composition of potential new net asset purchases. Key to success here is that the measures form a package of complementary and mutually reinforcing elements.

It is noteworthy how much we have in common with the central banks of most developed countries. We have independence, as well as clearly defined mandates. We aim at price stability and have floating exchange rates. We have not adopted any fixed monetary policy rule.

Accountability and transparency ensure public confidence. We understand the importance of expectations and communication. We have used non-standard monetary policy measures and have included them in our regular toolboxes.

At the same time, many central banks are reviewing their monetary policy strategies. The Fed is conducting such a review, as you well know. So is the Bank of Canada, which does it regularly. I have personally been advocating a review of the ECB's monetary policy framework.

The ECB – much like other central banks – operates in an environment where long run trends, such as population aging and lower long-term interest rates, as well as concerns about inequality and climate change can have important societal effects. It is acknowledged that the central banking community needs to understand better the implications of these structural changes for growth, employment and inflation dynamics, so as to deliver more effectively on our mandates.

There are other pertinent arguments for a strategy review. In the first place, monetary policy is conducted in an economic environment with low interest rates, inflation and even growth. This environment is very different to that of 2003, when the ECB last conducted a review of its strategy. Secondly, monetary policy is done with very different tools from those of 16 years ago. And thirdly, it is good practice to periodically bring the brightest minds in the academic community together with practical decision-making to evaluate our monetary policy strategies and conduct a systematic dialogue with civil society.

Ladies and Gentlemen, Dear Friends,

Regarding the economic outlook in general, a major challenge concerns the prospects for international trade and more generally various forms of international cooperation – not least the battle against climate change.

A multilateral approach to decision-making may sometimes be cumbersome and slow. However, we can ask whether is at all possible to deal with the current global challenges without a multilateral approach.

Here, global institutions play an important role. It is essential to maintain them, but at the same time to reform them to face new challenges. While the IMF has been able to adapt itself successfully to the post-crisis era, the World Trade Organisation is in great need of reform today. That could be one important transatlantic project for the coming years.

When we join forces, we are stronger. I am always happy to see Europe and the United States acting together and improving the multilateral system. I'd like to see more of that.

Thank you very much for your attention!

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[1] The official name is Economic and Monetary Union (EMU), but I use European Monetary Union here to adapt to a U.S. audience.

[2] The June 2019 Eurosystem staff forecast for the euro area foresees annual HICP inflation at 1.3% in 2019, 1.4% in 2020 and 1.6% in 2021.