Olli Rehn: Global and European economy from the Finnish perspective

Opening remarks by Mr Olli Rehn, Governor of the Bank of Finland, at the National University of Singapore, Singapore, 7 November 2019.

*   *   *

Accompanying slides of the speech.

Ladies and Gentlemen,

It is my great pleasure to be here in Singapore today and have the chance to discuss the economic outlook and monetary policy with you.

Singapore is a small and very open economy with a financial system that is highly integrated into the international financial markets. With a population of some 5.5 million, there is a whole lot that Finland and Singapore have in common. Never mind the fact that in Singapore's case the whole population lives in an area that is equal to the Helsinki metropolitan region! Anyway, we can both be proud of a high-quality education system and a skilled labour force that support an economy which is largely based on high-tech, innovation and R&D activity.

In my opening remarks I will discuss the global economic outlook with a particular focus on the euro area and the ECB monetary policy.

Some weeks ago, at the Annual Meetings of the IMF and the World Bank, the mood was pretty gloomy. The global economy is in a synchronised slowdown due to the prolonged pervasive uncertainty that is damaging trade and investment. Global growth forecast for this year has been downgraded to 3 per cent – the lowest level since the global financial crisis.

Deterioration of industrial confidence and a sharp and broad-based slowdown in global manufacturing explain the latest downgrade. The expected moderate pick-up of global growth in 2020 rests on a projected improvement in the performance in several of emerging markets and developing economies. Yet, there are elevated downside risks, including an escalating trade war, the ongoing Brexit concerns and the geopolitical turbulences in the Middle East. Thus, a much more subdued outcome could well materialise, with ramifications for both Asia and Europe.

In the euro area, we have been on a path of recovery and growth since 2013, when the euro crisis had been contained. Growth became gradually more robust and culminated in a 3 per cent expansion in 2017. However, growth has now decelerated to about 1 per cent. Yet, thanks to the falling unemployment, the labour market remains resilient and is keeping up domestic demand in Europe, e.g. in Finland. So far the weaknesses in trade and manufacturing have not suffocated the service sector and domestic demand, and we are not predicting recession.

Having said that, Europe faces its own structural problems, such as population ageing and declining productivity growth, as well as the long-term challenge of mitigation of and adjustment to climate change. And we have to add the UK debate on its relation with the EU, which resembles a Shakespearean drama – not his best work, though, as it has become rather repetitive – of "to Brexit or not to Brexit, and if so, how". The Brexit deadline has yet again been postponed, and the UK is now going to hold parliamentary elections in December. The recent estimates by the Bank of England suggest that successful preparations have softened the impacts of a worst-case scenario. However, a disorderly Brexit would still impose severe economic damage on the UK. For the EU27, the impacts vary widely between the countries with the order of magnitude being about 10 – 30 per cent of the negative impact experienced in the UK.

Maintaining an accommodative monetary policy stance

Inflation in the euro area has stubbornly continued to fall short of the ECB's target, and inflation is projected to remain subdued. In response, the Governing Council of the ECB substantially increased monetary accommodation at its meeting in September. With this decision, financing conditions will remain accommodative for an extended time period and contribute positively to the euro area's growth outlook.

The past decisions to restart the easing phase in March this year and to resume the net asset purchases in September were taken in response to the continued shortfall of inflation with respect to our target. This does not mean that we would close our eyes to possible negative side effects of unconventional monetary policy. However, as long as the synchronised global slowdown continues, there is no economically meaningful alternative to an accommodative monetary policy stance – and it is better to be safe than sorry.

In this context, monetary policy needs to make inflation expectations converge with the price stability objective. It is our ambition that as a result of our actions, we will see a rebalancing of the euro area economy and the normalisation of interest rates. Nevertheless, low interest rates, low inflation, and persistently low growth have put our economic theories and past empirical relationships to a real litmus test.

Discussions concerning a review of the ECB's monetary policy strategy have progressed over the year, and a broad consensus has emerged regarding its implementation. The ECB's new President, Christine Lagarde, has indicated her willingness to conduct such a review.

In my view, a successful implementation of the strategy review would deepen the research-based knowledge underpinning the monetary policy strategy and thereby enhance the common understanding on policy stance within the Governing Council. The review process should thus contribute to better monetary policy decision making and likewise support consistent communication on the monetary policy stance.

Next, I shall discuss two particular policy issues that play a major role in relation to monetary policy and the ECB decision-making. First, macropudential policy; second, the policy mix with fiscal policy.

Macroprudential policy as the second pillar of central banking

Post-crisis, **macroprudential policy has become the second key pillar of central banking today**, alongside monetary policy. Its guiding principle is that every country must find a macroprudential policy toolkit that is suitable for performing purposeful and well-targeted policies, and in general these toolkits should be made more comprehensive and wide-ranging than today. However, macroprudential toolkits are insufficient in many countries due to ongoing structural changes, like the growth of the non-bank financial sector and non-traditional loan products.

For instance, the traditional dominance of banks as providers of credit and finance has started to weaken. The growth of the non-bank financial sector has taken different speeds and forms in different countries and regions. A case in point is China, where the size of the non-bank financial sector was about 10% of annual GDP a decade ago. Now its size is over 100%.

Furthermore, we should not neglect the effects of certain global megatrends on macroprudential risks. For instance, rapidly expanding urbanisation is widening the regional differences in local housing markets and creating house price bubbles in some of the fastest growing cities. Digitalisation is creating previously unknown challenges to macroprudential policies. With the emergence of new players like FinTech and especially BigTech companies, new types of credit channels and changes in interconnectedness are affecting systemic risks in finance. And one of the even too "hot" topics in the macroprudential field is the long-term impact of global warming on financial stability. These will call urgent and focused attention by macroprudential policymakers.

Meanwhile, I find the debate on whether macroprudential policy should be formally part of the central banks' mandate as mostly exegetic, even theological – macroprudential policy is *de facto* the second pillar now, and *de jure* this fact has in Europe been anchored in the EU's secondary legislation, both as to the role of the financial supervisory authorities in the member states, and of the European Systemic Risk Board.

Need for a better policy mix

Moreover, many of the challenges we face are beyond the mandates of central banks. Better policy coordination – or policy mix – is key for better economic outcomes, especially since the monetary policy space is limited.

The challenges in the domain of governments and fiscal authorities are both long- and short-term in nature. Good examples of long-term structural issues are competitiveness and climate change. To deal with them, structural reforms need to be harnessed to boost productivity and the euro area's growth potential and to reduce structural unemployment.

Fiscal policy can affect economic activity in the short term. That's why automatic stabilisers should be able to play their full role. Moreover, while euro area economies have different fiscal constraints, fiscal measures should be actively pursued in countries where fiscal space is available. Such measures should be aimed at growth-enhancing public investment.

In this endeavour, further development of the euro area financial architecture plays an important role. We need to finalise the Banking Union and make true progress with the Capital Markets Union.

Moreover, sustainable finance will play a major role in the development of European capital markets. The European green bond market is the single largest green bond market in the world and the European Investment Bank is one of the largest multilateral providers of climate finance worldwide.

Ladies and Gentlemen,

To sum up: due to the prolonged pervasive uncertainty, we expect a period of slower growth – but no recession. Inflation is projected to remain subdued. That's why monetary policy will remain accommodative for an extended period of time. Moreover, a strategy review is an opportunity to enhance common understanding and consistent communication on monetary policy. Concerning flanking policies, macroprudential policy needs to be active and widen its toolbox, and we need a better policy mix where fiscal policy and structural reforms carry more responsibility for productivity and growth, so that monetary policy will not be the only active player in the field. And finally, we need to intensify the reform of the euro area architecture to make it more resilient before the next recession.

Many thanks for your attention.