Olli Rehn: Macroeconomic policy in times of global political upheaval

Keynote speech by Mr Olli Rehn, Governor of the Bank of Finland, at the Bank of Finland and Centre for Economic Policy Research (CEPR) joint conference "Frontiers of monetary economics in the 21st century: where and where to?", Helsinki, 13 May 2025.

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Ladies and Gentlemen, Colleagues and Friends,

Welcome to the sunny, spring-time Helsinki. On behalf of the Bank of Finland and the Centre for Economic Policy Research, it is my great pleasure to open this year's research conference on monetary economics – which again has an excellent and a most fascinating programme!

Let me begin with a mission statement – and a confession. Our slogan at the Bank of Finland is: "Securing stability – in science we trust." That is, we lean on evidence- and theory-based economic analysis and policy-relevant research to support our stability mission.

However, I must make a confession. In this turbulent world, it is comforting to return to a familiar setting and reflect on policy challenges alongside leading economists. Although only eight months have passed since our last gathering, it feels like the global landscape has shifted dramatically.

And the confession is this, in front of you as researchers, scholars, scientists, leading economists; in these times of pervasive uncertainty, we need plenty of judgment and scenario analysis to supplement our economic and econometric research and regression equations, thus making monetary policy, by necessity, is as much an art as a science. Such is life in these strange times – but finally, at least, it dis make me understand why the Governor at Bank of Finland is, *ex officio*, also the chair of the arts committee of the Bank!

Talking about geopolitics and its effects, just look at the ECB's evolving language. Uncertainty went from "increased" to "high," then "pervasive," and now, per President Lagarde, "exceptional." This isn't linguistic inflation. It reflects how genuinely hard forecasting has become, with markets pricing in risk at levels not seen in years.

Risks abound: from trade wars to faltering global alliances. For central bankers and researchers alike, this is no time for complacency. Instead of dissecting every new risk, today I want to focus on three key areas:

- Lessons from the recent inflation surge;
- Open questions around fiscal policy, particularly defence spending;
- And finally, the role of productivity and innovation.

Low inflation – past and future

Let's nevertheless recall there are some good news. The European economy is recovering. Unemployment is at 6.1%, the lowest since the euro's creation. Inflation has been hovering just above 2% since late 2023, allowing the ECB to cut rates seven times.

The energy shock that hit Europe in spring 2022 has played out very differently than in the 1970s, with the economic cost being much lower this time. Thanks to increased labour supply and lower working hours, wage-price spirals were avoided. Today's labour market is more flexible, less unionised, and better educated.

Importantly, inflation expectations were much better anchored before the recent inflation surge. This underlies the importance of central bank independence and a strong commitment to the inflation target. The ECB has focused firmly on maintaining these, and will continue to do so.

Before Covid, the main challenge was that inflation remained stubbornly below the target. Most risks to the inflation outlook were deflationary, including population ageing and the related increase in savings, and the low investment demand. And before the ECB's 2021 review and move to a symmetric 2% target over the medium term, which has worked well, the inflation target was perceived as a ceiling, creating a downward bias.

From around 2021, inflationary pressures reappeared. First this was due to the pandemic-broken supply chains and stimulus-fuelled demand, then due to the energy shocks arising from Russia's invasion of Ukraine.

We learned how demand and supply shocks can be deeply intertwined. But we still face many unknowns in that regard. Current geopolitical tensions may expose us to new surprises that we have little historical experience of. Preferably, the spectre of a prolonged trade war with the US will dissipate sooner rather than later, as an economic conflict between long-standing friends and allies is the last thing we need in a world challenged by dictatorial impulses and by a neocolonial mentality.

Furthermore, what if China shifts exports away from the US to Europe, slashing prices to compete? That could bring deflationary forces and industrial strain to the EU. Would it benefit consumers or hurt our economy overall? The policy response would not be straightforward.

Let's hope we don't have to answer these questions through crisis. Whatever the challenge, the ECB will remain focused on price stability and its symmetric 2% inflation target over the medium term.

Defence spending – new pressures

Since the pandemic, fiscal spending pressures have risen. Now, security concerns are adding fuel. Russia's aggression and doubts about US defence commitments are prompting big spending shifts across Europe. Germany is paving the way and has eased its constitutional debt limits.

We can assume that with normal execution lags the most substantial fiscal impact will start to be felt from next year 2026 and 2027 onwards. This implies that the fiscal impact on the growth and inflation outlook will take effect in the medium term, as an ordinary citizen perceives is, although this timespan of fiscal impulse will mostly be beyond the projection horizon of medium term as understood in monetary policy. Our assessment indicate a moderately significant impact on growth and limited impact on inflation in the relevant timespan.

Waking up and substantially increasing defence spending is welcome. Security is the bedrock of economic stability. Peace and security within European borders are fundamental to the European project and its economy. Defence should be seen as a European public good. Further support for Ukraine should also be seen in the same light.

But what does this mean for inflation? Historical comparisons to war-time money printing don't apply here. Independent central banks like the ECB remain focused on keeping inflation expectations anchored.

Still, we need to understand what type of shock defence spending represents. Is it demand or supply driven? Likely both, depending on how and where the money is spent.

We also face the question of *how* to pay for it. EU-level spending would offer more stability and efficiency. That might mean higher membership fees, new revenue sources, or even treaty changes. Defence bonds – as safe assets – are one option, but only if backed by solid future income.

Meanwhile, demands on public budgets are rising across the board: infrastructure, climate policy, aging populations.

What guidance do we have so far from economics research?

There is a large body of literature on fiscal multipliers, which incidentally often uses defence spending as a natural experiment or exogenous shock. These multipliers are frequently estimated to be below one, because public spending or investment usually crowds out private one.

However, evidence suggests that multipliers tend to be larger in times of recession and economic slack. Moreover, some of the best evidence on the magnitude of fiscal multipliers is based on US data, where the multiplier may be smaller. This is simply because the US defence industry is very large compared to its European counterpart and is thus more likely to face diminishing marginal returns.

All these issues mean that for European defence spending to be successful and sustainable, we must make every euro count. The additional defence spending should focus on investment in building up industrial network capacity and R&D, rather than simply procurement of defence equipment, which may be largely imported.

Then there is also the aspect of defence efficiency. For this, we need sound planning and coordination at the European level, as well as a common market for defence, as stressed in last year's Letta Report. Recent experience has shown that training in the use of unfamiliar weapons and problems with shortages of spare parts can become critical bottlenecks. Therefore, further harmonisation of technical standards and types of arms and equipment across European defence forces is key.

With a history of independent and diminished national defence industries, the EU has some considerable catching up to do. We need to increase both national and EU-level defence spending, e.g. as Bruegel has suggested, by establishing a European Defence Mechanism formed by a coalition of the capable and willing. Such a fund would bypass the limitations to raising EU-level income, be resilient to any intra-EU obstruction and could also accommodate countries from outside the European Union, like the United Kingdom and Norway.

In short: defence spending won't necessarily be inflationary. But to be effective, it must be efficient. We need smart investments – in industrial capacity, innovation, and R&D – not just procurement. And we must avoid fragmented efforts. A European Defence Mechanism, built by a coalition of the capable and willing, could also help to pursue these goals.

Innovation – defence and civilian

Let's now turn to innovation. Defence spending often yields big returns beyond the battlefield. Its effectiveness should be assessed from a long-term perspective, not only via short-run multipliers. Historically, it has given rise to technological breakthroughs that have not only found direct civilian applications but created whole new non-defence industries.

Walkie-talkies were created during the Second World War at Motorola for infantry and artillery communication. Radar gave us microwave ovens. Military satellites gave us GPS and digital imaging. Jet engines, nuclear energy, the internet – all have military origins. Dual-use in action.

Yes, these are cherry-picked examples. But they highlight that basic research often needs public support. The private sector tends to shy away from "unknown unknowns."

Modern defence is about technology, not just steel and troops. And there's often more pressure to innovate efficiently. Look at Ukraine – it has rapidly developed drone tech, despite scarce resources.

We know that Europe needs a productivity boost. For years, we depended on cheap energy from Russia, cheap goods from China and the security shield from the U.S. abroad. That stability was a mirage, if not a hallucination.

To maintain our living standards and sovereignty, we must double down on innovation by investing on human capital and creating a conducive environment for research and researchers. Whether it's AI, clean tech, green transition or digitalisation, we can't afford to lag behind. Innovation is not optional; it's vital for Europe's future – a necessary condition for sustaining Europe's quality of life and democratic values.

Why not use the EU Horizon programme to create a scholarship and visa programme for returning and moving scientists to attract talent to Europe, where critical thinking and academic freedom in universities are encouraged and safeguarded?

Dear friends,

Let me conclude. Europe finds itself in a puzzling paradox, which would be funny if it were not purely pathetic. As Polish PM Donald Tusk put it starkly recently by quipping as follows: "500 million Europeans are asking 300 million Americans to protect them from 140 million Russians."

We need to put an end to that paradox. Europe must take responsibility for its own external security, in today's harsh geopolitical world.

This isn't just about military strength. It's about cohesion, economic resilience and long-term growth. We need to spark Europe's industrial renewal, reinforce technological leadership, and enhance productivity.

As history shows, Europe tends to move forward in times of crisis. In every crisis there is an opportunity – this time round we must use it particularly wisely to make Europe more resilient and capable of thriving again.

Thank you.