

Olli Rehn: Europe's economy under the weight of power politics

Speech by Mr Olli Rehn, Governor of the Bank of Finland and First Vice-Chair of the European Systemic Risk Board, at the EU Heads of Mission lunch seminar, Helsinki, 2 June 2026.

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Presentation accompanying the speech

Your Excellencies, Dear Colleagues and Friends,

Welcome to the Bank of Finland! It is really nice to see so many of you again.

Today I will discuss the euro area economic outlook and the European Central Bank's monetary policy under the weight of power politics. As Elisa Newby mentioned, our Head of Forecasting, Juuso Vanhala, and his colleagues have the unenviable task of evaluating Finland's growth outlook under these difficult conditions.

I feel there are certain similarities between diplomacy and monetary policymaking in these testing times, when geopolitical rivalry and geoeconomic fragmentation are increasingly shaping global affairs and the economic outlook.

Both diplomacy and monetary policy require humility and judgement: the ability to distinguish between what we know and what we do not yet know, and to recognize which signals truly matter amidst the surrounding cacophony. In times such as these, resilience depends not only on decisive action, but also on balanced judgement and the capacity to maintain trust under conditions of uncertainty.

Slide 2: Geopolitics is casting a shadow over Europe's economic performance

Since the beginning of this year, the intensification of power politics has added to global uncertainty. Sudden spikes in energy prices and terms-of-trade shocks have weakened confidence and raised financing costs.

The countries involved in the Iran war are engaged in a struggle of economic and political attrition. As you are aware, each side operates according to a very different rationality from that of traditional diplomacy.

We should therefore be prepared for a prolonged conflict over control of the Strait of Hormuz, despite recent optimism. That is not a good prospect for Europe, but it is one for which we must be prepared. Should developments evolve more positively – and I'd be more than glad to be proven wrong – adjustment will be easier.

By contrast, markets are behaving almost as if there were no war. AI-related investments and strong corporate profits in the US have driven the country's equity markets to new record highs.

Economists are increasingly highlighting the prospect of strong productivity gains associated with AI. Comparisons with earlier technological revolutions, from the railway boom to the rise of the internet, have become commonplace.

History reminds us that such transformations are rarely smooth, however. Both the industrial revolution and the internet era were marked by sharp booms and busts, the rapid rise of new companies, and equally fierce processes of elimination. Yet despite failures along the way, technological progress continued and productivity ultimately increased.

Will this time be different? My expectation is that, in the short term, we are likely to overestimate the transformative power of AI, while in the long term we may underestimate it. That is worth reflecting upon, because the consequences will affect us all.

At the same time, the political climate in the United States has become increasingly unpredictable, both in geopolitics and in trade policy. Together with Russia's aggressive actions, this underlines the need for Europe to strengthen its common capabilities, particularly in defence and in the energy economy.

Slide 3: War in the Middle East slows euro area growth and accelerates inflation

The war in Iran is essentially a stagflationary shock: growth prospects have weakened while inflation has risen, at least in the short term.

This does not mean we are facing a return to the stagflation of the 1970s. But the nature of the shock is similar: weaker growth combined with higher inflation.

Both the ECB and the Bank of Finland have been working with two alternative scenarios in addition to a baseline, rather than a single forecast path. I view these scenarios as structured representations of possible futures. They help us organise our thinking and assess alternative policy responses.

At present, developments appear to be moving us closer to an adverse scenario, particularly when viewed through the lens of oil prices. Natural gas prices have risen less dramatically.

By our meeting next week, we will receive a new set of Eurosystem staff projections. I am therefore looking forward to fresh data and a deeper assessment of the inflation and growth outlook.

Going forward, I see in principle three possible paths.

The first is that the energy shock proves temporary. Inflation rises for a period but the effect remains largely confined to energy prices and then fades. In this case, monetary policy should avoid overreacting to the shock. This path appears less and less likely, day-by-day.

The second possibility is that inflation rises more significantly and remains above target for longer, but without generating broad-based second-round effects through wages or profit margins. In such circumstances, vigilance would be required, and the policy rate could, if deemed warranted, be increased as an insurance to ensure that inflation expectations stay anchored. But it would not imply a start of a hiking cycle or lead to a more forceful monetary policy response.

The third possible path is that the conflict becomes prolonged, energy prices remain elevated and inflationary pressures spread more broadly through the economy. If we were to see convincing evidence that inflation expectations were becoming de-anchored and that wage-setting behaviour was adjusting to persistently higher inflation, then monetary policy would need to respond decisively and quickly.

Thus, the conditions that justify tighter monetary policy are not higher oil prices alone. What matters for monetary policy is whether the shock risks getting embedded in the inflationary process.

What does fresh data tell us, for now?

Slide 4: Euro area medium-term inflation expectations derived from swaps remain anchored near 2%

Inflation expectations derived from euro area inflation swaps remain well anchored around the ECB's 2% target at short-to-medium-term horizons, regardless of the measure considered (2.02% – 2.16%). Over the past week, inflation expectations have edged down somewhat, but the change has been modest; expectations have remained anchored despite the temporary uptick that followed the outbreak of the conflict.

At the same time, the ECB's inflation forecast remains challenging, with inflation projected at 3.5% this year in an adverse scenario. That said, part of this forecast reflects mechanical factors, and increases in oil and other energy prices do not automatically translate one-for-one into broader inflation.

It is noteworthy that euro area swap-based inflation expectations remain lower than those in the United States. Besides, the recent decline in inflation expectations seen in the euro area has not been mirrored in U.S. markets over the past few weeks. The demand situation in the United States is generally stronger than in the euro area. Moreover, unlike in Europe, higher oil prices do not cause a negative terms-of-trade shock for the United States that nowadays is an oil exporting country.

Against that backdrop, while inflation risks have increased, a rate increase in June would be an insurance one, but not due to entrenched inflationary pressures.

That assessment could change if the conflict becomes prolonged and if the transmission from energy prices to wages and broader inflation proves stronger than currently witnessed. It is therefore critical to monitor incoming data exceptionally closely.

Slide 5: Every crisis is unique – no two crises are alike

Research by the Bank of Finland shows that geopolitical shocks have complex effects for the economy. This is why every crisis is ultimately unique, despite having some similarities with other crises. The same increase in energy prices can produce very different inflation outcomes, depending on the economic conditions at the time. Rising energy prices had very different impacts on euro area inflation in 2022 than in 2011, for example, when oil prices increased amid the Arab Spring.

The comparison with 2022 is instructive. At that time, the euro area economy was emerging from the COVID-19 pandemic. Demand was strong, fiscal and monetary policy remained very supportive, labour markets were tight, and supply chains constrained. Inflation had already accelerated substantially before the outbreak of Russia's war in Ukraine. The environment was therefore highly conducive to persistent inflation.

Today, the picture is different. Growth is weaker, labour markets are less tight, fiscal support is more limited, and inflation had largely returned close to target before the current conflict began.

Another useful point of comparison is 2011. Energy prices rose sharply following the Arab Spring and the Libyan civil war. Headline inflation increased significantly, but underlying inflationary pressures remained relatively subdued because the euro area economy was weak and burdened by the sovereign debt crisis.

The lesson from 2011 is not that central banks should ignore energy shocks. The lesson is that monetary policy must distinguish between a temporary relative-price shock and a persistent inflation process. That distinction remains just as important today.

This is why the ECB's monetary policy strategy emphasises both symmetry and a medium-term orientation. Inflation can fluctuate significantly in the short run, especially when energy prices are volatile. Our task is not to react mechanically to every fluctuation. Our task is to ensure that inflation stabilises sustainably at 2% over the medium term.

Slide 6: More than four years of full-scale war have changed Ukraine's economy

Before I conclude, I would like to share a few thoughts on Ukraine. More than four years of full-scale war have profoundly reshaped the Ukrainian economy.

The scale of the shock is difficult to overstate. Russia occupies around a fifth of Ukraine's territory, roughly 15% of the population have fled abroad since the invasion began, and by the end of 2025 the economy was about 20% smaller than in 2021. Last winter, Russia again systematically targeted energy infrastructure, causing prolonged power outages during one of the coldest winters in recent memory.

Yet Ukraine's economy has continued to grow. GDP expanded by around 2% in 2025, with the IMF projecting similar growth in 2026. The European Bank for Reconstruction

and Development attributes this resilience to macroeconomic stability supported by substantial external financing. For comparison, Russia's economy is forecast to grow by only 0.8% in 2026 – the aggressor is not winning the economic war.

The war has also transformed the structure of Ukraine's economy. Agriculture now accounts for around 60% of exports, up from 40% before the war, while defence manufacturing has nearly tripled since 2021.

Moreover, in just three years, Ukraine has built a thriving drone industry from a very limited base.

This experience provides four macroeconomic lessons. These lessons are relevant not only for Ukraine, but also for Europe's thinking on resilience, defence industrial policy and the role of international financial support in modern conflict.

Slide 7: Lessons from Ukraine

Gradual, sequenced deregulation stabilises a crisis economy

A common wartime instinct is to impose price controls and restrict capital. Ukraine has largely resisted this, and the results support that choice. Emergency capital controls introduced after the invasion were gradually unwound as conditions stabilised, with some forex operations and capital flows restored already in 2023. This measured deregulation strengthened confidence among both citizens and foreign investors that Ukraine could maintain a functioning financial system even in wartime. Ukrainians largely kept their savings in the banking system and in the national currency, Ukrainian hryvnia, helping preserve financial stability.

Crises catalyse innovation and speed up how things are done.

Ukraine's drone industry shows not only what can be produced under pressure, but how quickly systems can adapt.

Traditional defence procurement is often slow and centralised. Ukraine developed a different model: rapid battlefield feedback, continuous design updates, and a network of around 500 agile manufacturers able to respond in real time.

The economy is the second frontline

Modern wars are sustained not only by weapons, but by industrial capacity, supply chains, public finances and social resilience. Ukraine's defence manufacturing has nearly tripled since 2021, supported by a functioning market economy that has kept businesses and workers operating. Ukraine's fiscal deficit in 2025 was 25% of GDP, financed largely through more than \$50 billion in external support. This means that international budget assistance has become a strategic contribution to the war effort itself.

Institutional reform under pressure is hard but failure is costlier

Wartime conditions create fertile ground for corruption through opaque procurement and emergency powers. Much of Ukraine's external financing is tied to reform and anti-corruption progress, reflecting the reality that corruption weakens defence capacity and undermines reconstruction.

Ukrainians themselves have shown strong support for accountability, including public protests in 2025 after the country's parliament moved to limit the independence of key anti-corruption agencies.

Slide 8: Europe's strategic triple test

Let me now conclude. Europe's ability to navigate in the world of power politics will depend above all on its capacity to reform and stay united. Europe faces a triple test: defence, energy and productivity.

First, Europe must take greater responsibility for its own defence – preferably as the European pillar of NATO. This will require stronger joint investment and procurement, in order to ensure that the increased resources are used efficiently and capabilities genuinely strengthened.

Second, the latest energy crisis underlines the need to consistently continue advancing the green energy transition. This is not "only" a matter of climate, but essential for our energy resilience and security policy.

Third, Europe must invest in human capital, deepen its capital markets, cut the red tape, and promote innovation. Without stronger productivity growth, our long-term prosperity will not rest on a sustainable foundation.

The choices made in these three areas, both at EU level and by Member States, will shape Europe's economic future and strategic capacity to act.

In this context, monetary policy will act with a steady hand and ensure price stability, thus supporting sustainable growth and job creation.

Thank you very much for your attention.