

SUOMEN PANKKI
EUROJÄRJESTELMÄ



FINLANDS BANK
EUROSYSTEMET

In science we trust? – European Enlightenment in the harsh world of geopolitics

Joint Research Centre
Seville, 2 April 2025

Governor Olli Rehn
Bank of Finland

Themes of today's talk

1. European integration rooted in the era of the Enlightenment

2. Europe's security challenges due to current geopolitical developments

3. Strengthening Europe's security and economic prospects

Geopolitics is dominating today's economic developments with an exceptional force

Europe

- **Russia, Ukraine, Europe's security**
- Productivity and industrial competitiveness

Global troubles

- **Rules-based international trade under threat**
- Middle East conflict and shifting power relations
- Climate goals slipping: on track for +2.5°C/+3.0°C?

United States

- Relations with Europe?
- Future of democracy and the rule of law?
- What is "the West" now?



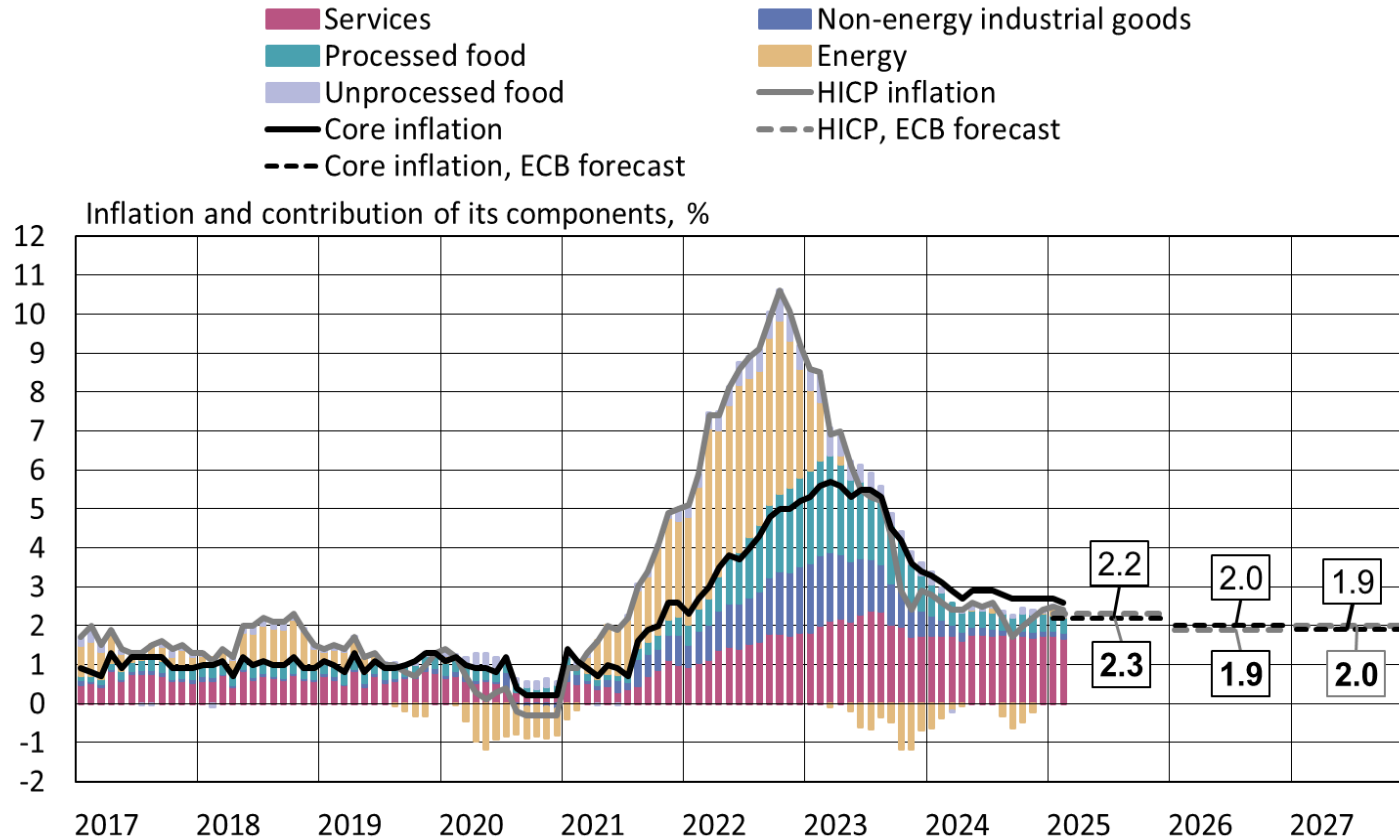
Asia

- China's economic woes
- India now world's most populous and fastest growing G20 country
- Asia's century under way – or will it collapse to conflict in the South China Sea?

Defence of Europe: a public good in the need of national and EU financing

- Security a European public good, and it has major externalities.
 - Common European measures are justifiable, especially when it comes to cross-border projects.
- European Commission's newly published proposals seek to ensure sufficient finance:
 - 1) Activating the national escape clause due to the current exceptional circumstances: higher defence spending by Member States would not trigger an excessive deficit procedure.
 - E.g. 1.5% GDP increase in defence budgets → nearly EUR 650 billion in fiscal space over four years
 - 2) EUR 150 billion loan instrument for defence investments:
 - Emphasis on common European projects
 - Finance through issuing common debt
 - 3) Utilising the EU budget: use of cohesion funds for defence spending.
 - 4) Mobilising private capital for defence projects through the EIB.

Euro area inflation stabilising at the ECB's 2% target

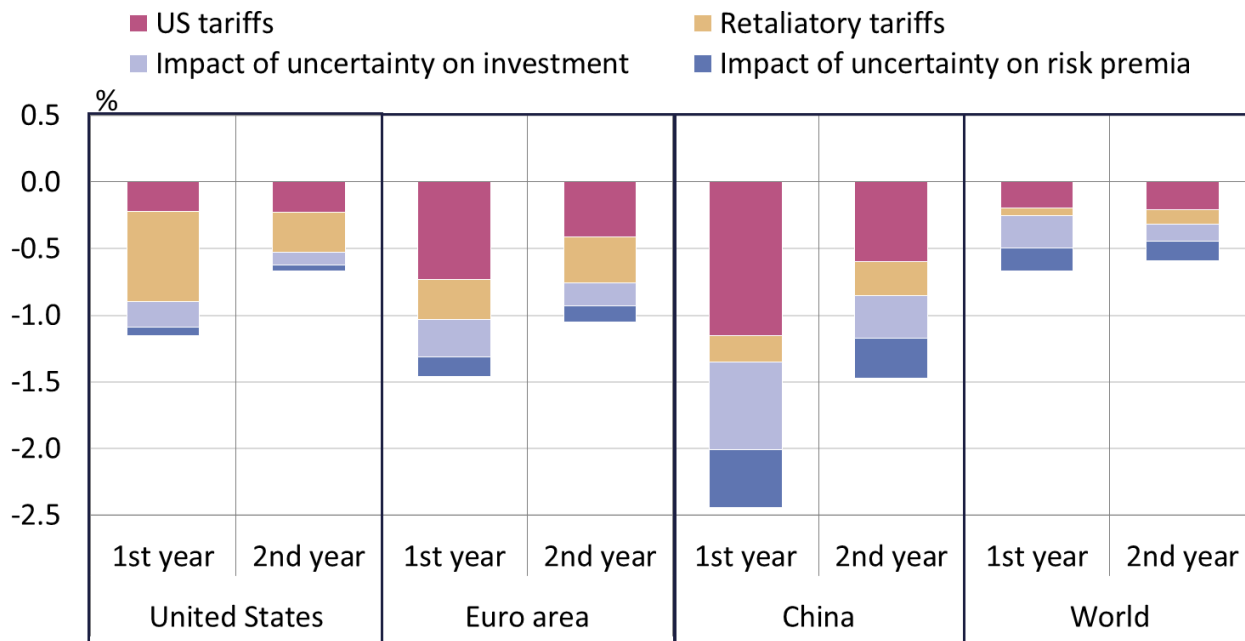


Sources: Eurostat and ECB.

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- Wage inflation is projected to slow.
- Most measures of underlying inflation suggest inflation will settle sustainably at around the ECB's symmetric 2% target over the medium term.
- Since last June, the ECB Governing Council has reduced the policy rate six times in a row, by a total of 1.5 percentage points (4% → 2.5%).
- The ECB is not committed to any rate path but preserves full freedom of action, as uncertainty is pervasive.

Bank of Finland's scenario calculation: A trade war would weaken growth worldwide



Source: Calculations by the Bank of Finland.
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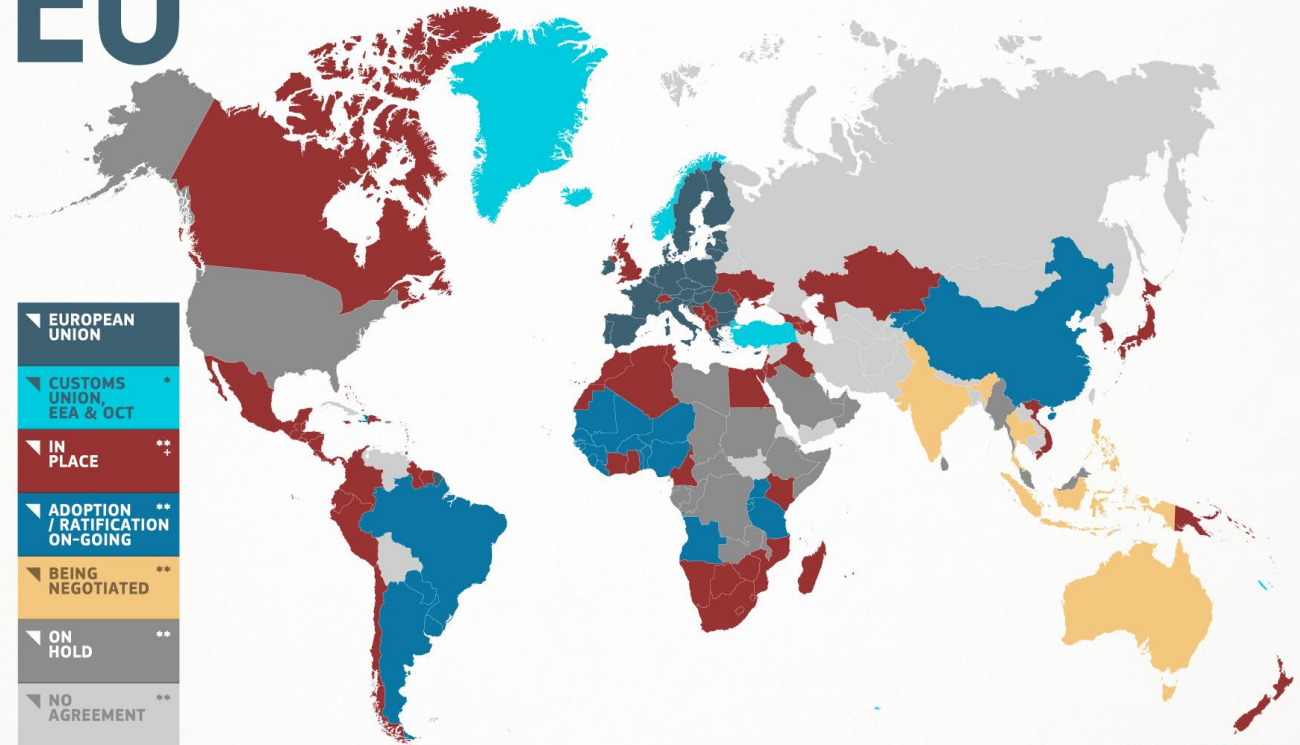
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- Assumptions: 25% US tariff on all imports from the EU; 20% US tariff on all imports from China; symmetric encounter measures. The increase in uncertainty is taken into account.
- Large variation in scenarios, e.g. the Kiel Institute for the World Economy: Euro Area GDP -0.4% p.a.
- No winners in a trade war. World GDP – 0.5% per year. Stronger impact on the EU and China. Counter measures weaken US companies' market positions.
- Apart from tariffs, uncertainty related to trade disputes will hit investment and raise risk premia.
- Impact on inflation moderate projected moderate.

EU free trade agreements in force and in progress

EU trade agreements 2024

Updated 24/07/2024



* European Economic Area (EEA) / Overseas Countries and Territories (OCT).
** Free Trade Agreement (FTA), Deep and Comprehensive Free Trade Agreement (DCFTA), Investment Agreement, Enhanced Partnership and Cooperation Agreement (EPCA), Partnership and Co-operation Agreement with preferential element (PCA).
+ The updated agreements with Tunisia, and Eastern and Southern Africa are currently being updated; the updated agreement with Chile is under ratification. The DCFTA with Georgia does not apply in South Ossetia and Abkhazia.

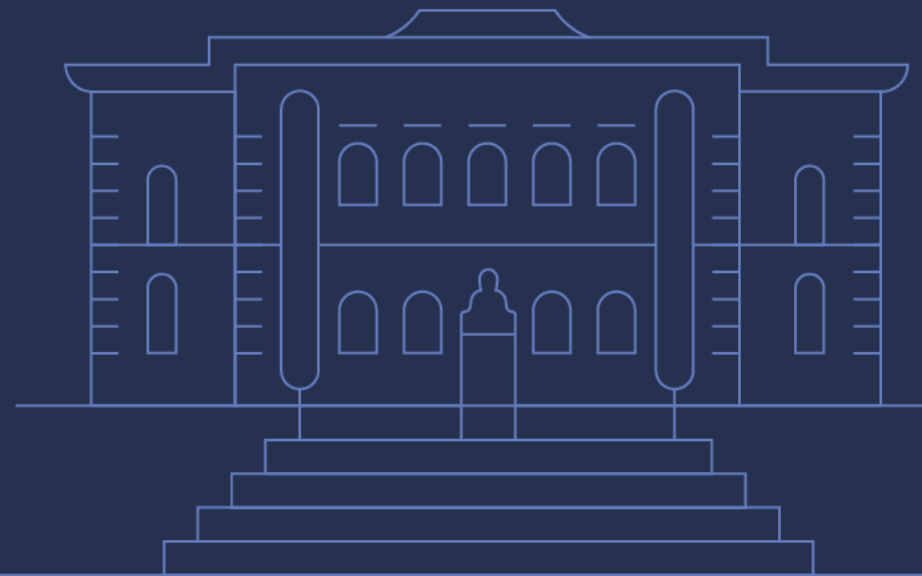


Europe is under challenge from the world of geopolitics – investment needed now in security and productivity

- The world is in transition, as it was 30 years ago – but is now moving in a reverse gear.
 - All of Europe must invest substantially in security and defence.
 - Necessary investment in defence is having to be made in an environment where public finances are under pressure. Common European solutions are also needed.
 - At the same time, Europe must find ways to increase productivity. The single market must be finalised and investment made in human capital and research.
- Requires that Europe has the capacity for renewal and stay united. A common response is more critical than before. No time to waste. Stand together and act with purpose.



” *Securing stability,
in science we trust.*



Reflections on the ECB's strategy review in 2025

- **No need to change the symmetric inflation target of 2% over the medium term.**
- **BUT need a better understanding of the inflation dynamics of recent years and of the secular trends affecting monetary policy going forward, for instance:**
 1. **Geopolitics and fragmentation:** increasing supply shocks & inflation volatility?
Analyse both **supply** and **demand** shocks
 2. **Labour markets in transformation:** rise in the employment rate and immigration; a secular decline in labour productivity growth
 3. Contradictory tendencies in **the long-term real natural rate of interest r^***

National responsibility is major element: Germany about to decide on major spending boost

- Easing of constitutional ‘debt brake’ (structural deficit limited to 0.35% of GDP) and expansion of spending:
 - 1) Exemption from debt brake for defence spending in excess of 1% of GDP.
 - Also includes defence aid for e.g. Ukraine.
 - 2) EUR 500 billion over 12 years for investment in infrastructure.
 - Approx. 20% of investment to be in green transition.
 - Other sectors: transport, energy, health and communications.
- GDP comparison (2024): Germany EUR 4,305 billion, euro area EUR 15,153 billion.
- Impact on the economy will ultimately depend on the details of the package:
 - How productive are the investments?
 - How big a share of the defence spending goes to European producers?
 - Will the increased spending affect price levels?