Monetary Policy Imperatives in a Changing Global Landscape - Remarks by Governor Gabriel Makhlouf - National Association for Business Economics International Symposium

13 May 2025 Speech

Good morning, and welcome to day two of the International Symposium.[1]

Many thanks to National Association of Business Economics for the invitation to speak, and for partnering with the Central Bank of Ireland to co-host this year's event.

The theme of the Symposium, "Trade, Technology, and Policy: The Changing Dynamics of Growth", makes it a valuable opportunity for policy makers, business leaders and researchers to hear about the issues facing the global economy. It comes at a time when perhaps it is more important than ever for transatlantic colleagues to hear about each other's challenges, and how they are preparing to face them.

Building on yesterday's sessions on the growth outlook, regulatory divergence, and AI and labour markets, today we can look forward to hearing about the drivers of medium-term growth prospects, trade, digital currencies, and geopolitics. I particularly enjoyed yesterday's talks by Governor Kugler and Megan Greene. Perhaps not surprisingly for a central banking trio, there is some overlap with my own remarks. But, as you might expect, I bring a euro area perspective on things.

If the last few years, not to mention the last few weeks, have taught us anything, it is that the optimal economic policy mix is one that needs to include both resilience-building measures alongside the right macroeconomic policies. These two themes form the basis of my remarks today.

First up is monetary policy where I will give my view on the economic outlook, and what this might mean for our near-term decisions. I will also set out some thoughts on the broader policy framework.

The second theme is on resilience building. To state the obvious, recent events provide the impetus to build a stronger Europe and I agree with my French counterpart and colleague, François Villeroy de Galhau, when he described three economic priorities as the "three I's": full integration of the single market, investing better in breakthrough technologies, especially in AI, and innovating faster by reducing bureaucracy, both within and across countries.[2] My focus today is on the first two – integration and investment – without wishing to downplay the importance of innovating faster.

But first, monetary policy.

Monetary policy: a framework for the road ahead

In preparing these remarks, I remembered that almost exactly two years ago I spoke at this venue on the theme of geoeconomic fragmentation.[3] At the time, I described it as a potentially large and significant change. Well, this year we can say without much qualification that the global economic integration that has characterised most of the last half-century is now stalled if not reversing.

We have moved from potential change to its realisation, and in the last few weeks its acceleration in both pace and scale. The sudden shift has led to increased financial market volatility across the world, reminding us all of the fact that global trading systems and global capital flows are two sides of the same coin. As a country at Europe's western edge, but at the heart of the European Union, and indeed the euro area, Ireland plays an important role in the global financial ecosystem. We are a highly globalised economy, with a large outward-focused financial sector. We see significant capital flows through our financial system and we have been closely and carefully analysing daily trade flow data during this period of volatility.

For businesses, the resulting scramble to adjust sourcing strategies will further fragment supply chains. We can already see this in shipping statistics – a reliable indicator of supply chain problems during the pandemic – where expected volumes at US ports are falling. Having declined throughout 2023 and much of 2024, euro area goods imports from China are up, especially in the first two months of 2025. Whether or not this is the beginning of a longer-term trade diversion effect remains to be seen.

Uncertainty is also weighing on investment, with soft data pointing to a significant cooling in business and consumer sentiment. The recent IMF World Economic Outlook highlighted tariffs, policy uncertainty and tighter financial conditions as significant drags on growth.[4] Even if a full-blown trade-war turns out to be short-lived, the uncertainty effects will persist for some time. Amplification risks from elevated public and private debt levels, and how these might ripple through the financial system, are a further downside risk.

Near-term path

The tariff announcements on 2 April prompted a re-assessment of what had been previously projected for the euro area economic outlook. GDP growth forecasts in the ECB staff projections in March of just 0.9 per cent in 2025 were still below potential, but there was a growing sense from the data – notably PMIs, credit growth and contacts with firms – that the outlook was improving. There was also a positive surprise in the Q1 2025 euro area GDP estimate, at 1.2 per cent year-on-year, although this data does include substantial front-running of goods exports to beat tariffs.[5]

An improving outlook (pre 2 April), increasing confidence of hitting our 2 per cent target, plus the fact that our policy rate was approaching the top-end of the range of estimates for the neutral rate, prompted a language change in our March monetary policy statement. Having previously talked of our monetary stance as "remaining restrictive", we changed it to "meaningfully less restrictive". Markets took this to mean a more gradual approach to further interest rate cuts.

However, the tariff announcement on 2 April, the pause on 9 April, and the further escalation in the case of China all combined to reduce the optimism on growth. At our last meeting on 17 April, we cited a deterioration in the growth outlook as a result of rising trade tensions as a downside risk factor for inflation. Hence the decision to reduce rates by 25 basis points.

In my view, one thing that is clear is that monetary policy must adapt to the new nature of supply shocks generated by geoeconomic fragmentation. Given the effects of the size, scale and more persistent nature of fragmentationinduced shocks, and their impact on prices, our monetary policy responses will need careful calibration.

Looking ahead – and with so much uncertainty around what the new geoeconomic framework will turn out to be – scenario analysis gives a sense of the range of possible outcomes.[6] On trade, the scenarios could fall between two possibilities.

In the first scenario, the threat of tariffs is short-lived, but uncertainty over trade policy persists, weighing on growth through lower investment and weaker sentiment. Exactly how long the uncertainty effects persist, and the extent to which they might spill over to financial markets, is unclear, hence the Governing Council's ongoing emphasis on being data dependent.

In the second scenario, the so-called "reciprocal" tariffs become a permanent feature, prompting retaliatory measures which have a more negative impact on growth.

A third hybrid-scenario is one where the US agrees a trade deal with the EU, but a trade war with China persists. This could have implications for euro area firms through negative spillovers to foreign demand and – more importantly for inflation – via a diversion of Chinese exports to the EU.

It should be the case that the first scenario is deflationary, with dampened demand, tighter global financing conditions and the appreciation of the euro all playing a role. It is unclear how China-EU trade diversion might play out, but I also see this as largely deflationary, mainly for goods prices. The dollar depreciation since early April suggests a capital outflow from the US, outweighing the lower import demand effects that would have led to an appreciation.

The inflationary effects of the second scenario, and its time horizon, are less clear. On the one hand, a weaker growth outlook puts more downward pressure on prices. On the other, retaliatory tariffs and supply chain disruption put upward pressure on prices.

I should add that scenarios do not represent predictions, but instead are useful exercises to think through the implications of different potential states of the world. We will always need to remain vigilant and flexible, ready to adapt to any further changes in the global landscape.

That's the near-term and, of course, in terms of policy and our medium-term 2 per cent price stability objective, the growth outlook and the risks are even less clear.

Monetary policy framework: the medium-term

Let me now turn to two issues with implications for monetary policy over the more medium term: expansionary fiscal policy in the euro area and more frequent supply shocks.

We are witnessing an increase in announcements of growing fiscal expenditure in some euro area countries, particularly Germany, focused on defence and infrastructure, sectors that have seen limited domestic production in recent decades, and which historically rely heavily on immigration as a source of labour. The reallocation of capital and labour required by this shift could create inflationary pressures, through several channels:

- A crowding-out of productivity, where production efficiencies are potentially lost as resources are diverted from areas of high productivity to sectors with more limited productivity growth, and where domestic capabilities have been less of a focus in the recent past.
- Market concentration in defence and related sectors is a further complicating factor. If firms can exert pricing power, this has the potential to amplify inflationary pressures.
- Labour supply constraints add another layer of complexity. The ageing workforce across advanced economies is happening at precisely the moment when new investment demands more workers.
- The interaction between labour market dynamics and fiscal policy deserves particular attention. For example, governments could tailor policies and incentives to facilitate labour reallocation, including adjusted retirement ages, training funds, targeted tax reliefs, and pension reforms.

On the other hand, infrastructure investment could also support the supply side of the economy and absorb existing slack in the manufacturing sector while defence spending could have positive spillovers on R&D and productivity more broadly (as we've seen elsewhere). The inflationary impact will depend on the details of any plans, such as the composition of expenditure increases, the import content, along with its financing and speed of implementation.

There is clearly a lot to pay attention to and I will continue to monitor how these developments play out, assessing the net impact on the inflation outlook (including the wider impact and developments on the economy) and, along with my Governing Council colleagues, respond accordingly.

The second issue, and perhaps one of the most pressing in terms of thinking about our monetary policy framework, is how should monetary policy respond to larger and more frequent supply shocks?

The traditional approach is to 'look through' supply shocks, based on the idea that they create a temporary trade-off between inflation and economic activity that monetary policy can't resolve without causing greater damage. However, the pandemic and the Ukraine war have revealed the difficulties of this approach. With the benefit of hindsight over developments in oil and gas prices in particular, we were perhaps somewhat slow to lift off from accommodative policies as inflation surged. Analytical and forecasting toolkits struggled to incorporate previously under-explored economic dynamics, including state-dependent pricing and the role of sectoral supply shocks in aggregate inflation that increased the size and persistence of the inflation shock. And forward guidance constrained the need for agility in responding.

Several lessons have emerged from these experiences.

First, monetary policy transmission can operate through a myriad of channels, some of which were perhaps not given enough weight in the past, given the experience of the first two-decades of the euro. This includes inflation de-anchoring mechanisms, production network effects, household and firm heterogeneity, the frequency of price-setting at the firm level and non-linear relationships like the Phillips curve at different inflation levels.

Second, the scale and persistence of recent supply shocks have demonstrated that 'looking through' isn't always appropriate when shocks are large enough to risk unmooring inflation expectations.

What are the implications for our monetary policy framework?

First, we have seen that threats of inflation de-anchoring, from both above and below, warrant forceful and persistent responses. Once inflation expectations drift from target, the costs of bringing them back are substantially higher than preventing drift in the first place.

Second, central banks will need to incorporate risk and uncertainty more explicitly into their frameworks. Depending on the risk environment, this could involve reducing the emphasis on a baseline scenario and increasing the emphasis on robust scenario analysis. Policy reaction functions may need to become more time-varying, responding differently to similar inflation readings depending on the risk environment. We saw some of this in practice in recent years with the introduction of the three criteria that guide the Governing Council's reaction function, namely the assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. As President Lagarde has pointed out, "The relative weights assigned to the elements will have to be regularly examined and, as past experience has shown, will likely change as events unfold."[7]

Third, we must ensure that our frameworks are sufficiently agile to account for sudden changes in the economic environment in order to allow for a swift exit from policies should there be a change in the state of the economy. The challenge here is to achieve this without denting policy credibility. For certain tools, such as forward guidance, flexibility is not a free lunch. The incorporation of exit clauses, for example, may lead to a questioning of the commitment to a given policy path, thereby blunting the effectiveness of the tool in the first place. But for me the emphasis should be on agility and, in my view, the era of time-based forward guidance is over.

Fourth, and finally, interest rates remain the default policy lever in our toolbox. However, when constrained by the lower bound, other policy tools such as targeted lending programmes and balance sheet operations have their uses. That said, I believe there is a case to be made for the use of quantitative easing tools to become more nuanced. In particular, we could differentiate between approaches depending on whether the objective is addressing transmission risks, market dysfunction and managing financial stability risks, or whether it is to provide accommodation at the zero lower bound.

Resilience-building measures

Having worked for large parts of my career in two small open economies – New Zealand and now Ireland – building economic resilience has been a recurring theme of mine.[8] We are already in a period of transitions – in demography, in climate, in technology – and we are now witnessing a rapid change to a new geoeconomic framework. All transitions pose challenges and all transitions need to be managed through building economic resilience so that households, businesses and the community as a whole can weather the storms but also take the opportunities that change provides.

In terms of priorities for resilience building, I would highlight three: (1) complete the Single Market to deliver deeper and stronger ties within its 27 Member States, (2) deliver a savings and investment union to complement the Single Market, and (3) launch the digital euro to ensure strategic autonomy in European payments.

When the Draghi and Letta reports on competitiveness and strengthening the Single Market were released last year, much of discussion centred around the need to boost European economic growth, including closing the productivity growth gap with other countries such as the US. Given recent events, however, the recommendations can also be viewed through an economic resilience lens. For too long, Europe has maintained high internal barriers and deepening the Single Market offers a hedge against broader global trade fragmentation. The EU is the world's largest trade bloc and a major global player in international trade, accounting for around 14 per cent of world trade. As the world's third-largest economy, a more integrated and efficient Single Market will help to reduce an over-reliance on external dependencies, foster innovation, and ensure stable growth. Furthermore, addressing fragmentation within its own market not only safeguards the EU economy, but also reinforces its global influence.

Deepening market integration by harmonising regulations – some of which we heard about in yesterday's regulation session – removing trade barriers, and incentivising cross-border investments mitigates supply chain risks by boosting intra-EU trade and diversifying sourcing. There are of course limits on how far internal sourcing can go in some sectors, like semiconductors and critical minerals. But in others, notably energy, the EU can and should reduce its exposure to external shocks.

Fragmented national markets limit growth, especially for small and medium-sized enterprises, where the initial fixed costs of cross-border trade can act as a barrier. A stronger Single Market brings economies of scale that would allow European firms to innovate and invest more efficiently.

This is already a priority for the European Commission, which has sought to streamline digital and green transitions with unified standards in, for example, AI, crypto, and renewable energy. The ensuing reduction in compliance costs supports a business environment where European companies can succeed on the global stage.

Two final thoughts before concluding, both in the broad area of 'financial architecture'.

Completing the Savings and Investment Union goes hand-in-hand with a deeper and stronger single market. Given that capital goes hand in hand with trade, a less open US economy could lead to a redistribution of capital flows through Europe, which further highlights the importance of completing the Savings and Investment Union. The public and private spending uplift that will be required to fund the transitions we face will be enormous. As I said earlier this year, the prompt delivery of the Savings and Investment Union is a key enabler to unlock the almost €12 trillion in savings and cash deposits held by Europeans.[9]

Digital Euro and resilience in payments

As I have also said previously, the European payments ecosystem remains without an EU-owned digital payments method that fully meets user needs.[10]

While in recent decade's card payments have grown to dominate non-cash transactions, it remains a fragmented system.[11]Furthermore, this ecosystem is dominated by non-EU providers, especially for cross-border payments.

Given the critical role of the payments infrastructure, for the economy, the conduct of monetary policy and the overall soundness of the financial system, we need to ensure that it is robust to economic, technological and geopolitical risks. In the current environment, relying on non-EU providers is unsatisfactory.[12]

The lack of a unified, pan-European payment rail (that does not rely on foreign providers) is a key vulnerability for the euro area. A central bank digital currency (CBDC) such as the Digital Euro can fill the gaps in our current fragmented pan-European infrastructure, while also encouraging innovation and competition in payments, and delivering in terms of strategic autonomy. A CDBC can deliver in terms of resilience, efficiency and innovation. This is an essential to shore-up the resilience of our 'financial plumbing system', and one that will deliver long-term and reliable benefits for business and consumers alike. The changed geopolitical landscape gives further impetus to improving our plumbing. As was recognised at the recent Euro Summit, "accelerating a digital euro is key to support a competitive and resilient payments system, contribute to Europe's economic security and strengthen the international role of the euro".[13]

Conclusion

To conclude, we face a new global economic order characterised by trade fragmentation, structural economic shifts, more frequent supply disruptions and policy unpredictability. Uncertainty is the new certainty and navigating such an environment requires adaptability from both policymakers and businesses.

For businesses, it means developing more resilient operational models that can withstand supply chain disruptions and regulatory changes. The most recent wave of globalisation was driven to a large extent by efficiency considerations. The next wave will need to complement this with strategies that build resilience through geographic diversification, agile inventory planning, and financial innovation, including in payments. We should also recognise that the majority of the world continues to believe in a multilateral rules-based trading system and we need to be ready to work with trading partners that think similarly to us.

For policymakers, agility and flexibility will be important, while also maintaining core principles of price stability, fiscal sustainability (something I have not mentioned today) and – I would add a third one – resilience-building. Nobody welcomes the geoeconomic fragmentation we are currently experiencing, but I believe it merely serves to accelerate changes that up to recently have been more gradual.

To a large extent, it brings to a head decisions that, for Europe, have been put off for far too long. In that sense, I am reminded of Edward Luce's description of Henry Kissinger's reasoning for his regular meals with his long-time Washington rival Zbigniew Brzezinski: "One always learns more from 'friendly critics' than from uncritical friends."[14]

I hope you enjoy the rest of the symposium.

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[1] Thank you to Rea Lydon, Daragh Clancy and Conor O'Shea for their help in preparing these remarks.

[2] "Preserving our transatlantic values, beyond present unpredictability", speech by François Villeroy de Galhau, Governor of the Banque de France, New York, 23 April 2025.

[3] Geoeconomic fragmentation from a small open economy perspective, Gabriel Makhlouf, Address to the Global Interdependence Centre Conference, Dublin, 16 May 2023.

[4] View the flagship IMF reports published during the Spring Meetings for more information – the World Economic Outlook, the Global Financial Stability Report and the Fiscal Monitor.

[5] For example, goods exports from Ireland to the US surged by 81 per cent in January and 210 per cent in February. These goods were mostly pharmaceutical and medicinal exports, which also represent a large share of the euro area exports in this area. Therefore, fluctuations of this magnitude can impact GDP dynamics for the entire bloc.

[6] The ECB is making greater use of scenario analysis related to tariffs and fiscal policy changes.

[7] “Building confidence in the path ahead”, March 20, 2024, Speech by Christine Lagarde, President of the ECB, at The ECB and its Watchers XXIV Conference.

[8] In one of my first speeches in Ireland, in 2019, I described economic resilience as the ability of an economy to manage change, whether it was to withstand or recover from the effects of shocks or the more gradual evolution to a different state.

[9] “Building Economic Resilience”, Speech, Governor Gabriel Makhlouf at the IIEA, February 2025.

[10] Governors Blog – Digital dividends: Unlocking innovation in the payments ecosystem.

[11] ECB Report on card schemes and processors (PDF 346.38KB).

[12] The digital euro: maintaining the autonomy of the monetary system – Speech delivered by Philip Lane at University College Cork Economics Society Conference 2025.

[13] Euro Summit Statement 20 March 2025.

[14] Edward Luce – Weekend Essay 12 April 2025.