Christine Lagarde: Trade wars and central banks - lessons from 2025

Keynote speech by Ms Christine Lagarde, President of the European Central Bank, at the Bank of Finland's 4th Monetary Policy Conference "Monetary policy in the shadow of geopolitical tensions and trade conflicts", Helsinki, 30 September 2025.

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Here in Finland, the idea that economics cannot be separated from geopolitics is hardly new. During the early 1990s, as the Soviet Union collapsed, Finland lost more than 10% of its GDP when trade with its eastern neighbour suddenly evaporated.[1]

Few countries know better the costs of ignoring geopolitical realities.

Today, the rest of Europe is facing a similar reckoning. We find ourselves in a new world – one where policymakers can no longer confine themselves to traditional economic and financial variables. Now, we must factor "geoeconomics" into our analyses.

The term was coined in 1990 by Edward Luttwak, who described geoeconomics as "the admixture of the logic of conflict with the methods of commerce". It is not protectionism in the old sense of sheltering vulnerable industries. Instead, it is trade deployed as a tool of power, a strategy of influence and dominance.

This approach has been around for some time, most visibly during the US-China trade disputes that unfolded during the first Trump Administration. The unjustified war in Ukraine and the sanctions that followed have also reshaped the European landscape. But 2025 marks the first year in which Europe itself has been on the receiving end.

We currently face the highest tariffs since the days of Smoot-Hawley in the 1930s, imposed by our largest trading partner. Global trade is being reshaped as other countries respond to tariffs directed at them. And in the span of just a few months, we have seen a surge in trade uncertainty and sharp swings in exchange rates.

So now is a good time to take stock of what we have learned so far, and what this implies for monetary policy.

Trade wars: expectations versus reality

A year ago, most would have assumed that US tariffs rising from 1.5% to 13% would trigger a major adverse shock to the euro area economy. Indeed, most trade models judged the imposition of tariffs to be, on net, negative for euro area growth and likely positive for inflation, at least in the short run.

This was broadly our internal assessment in December of last year, albeit surrounded by considerable uncertainty. Three channels were usually seen as decisive in producing such an outcome.

First, retaliation. Reciprocal tariffs were expected to raise import costs and reverberate through supply chains. In most models, this retaliation channel was by far the largest driver of higher short-term inflation.[2]

Second, the exchange rate. Tariffs were expected to trigger a depreciation of the euro against the dollar – driven by expectations of higher US rates and a smaller US trade deficit – thereby amplifying imported inflation.[3]

Third, uncertainty. Elevated trade policy uncertainty was expected to weigh heavily on business investment and growth, often more than the direct effect of tariffs on exports themselves. This was expected to be the largest negative force on growth.

Yet some of these assumptions have not been borne out.

This is because the tariffs were not an isolated economic event, but a symptom of a broader geopolitical shift – one that triggered political economy dynamics beyond the reach of standard models.

Start with retaliation.

In Europe and globally, it has so far been limited. In response to the US tariffs on steel and aluminium, the EU announced counter-tariffs on around €26 billion worth of American goods, but suspended them once a deal was struck in July.

Pressure from major industrial groups to avoid a prolonged cycle of tit-for-tat measures, as well as concerns about jeopardising US support for the war in Ukraine, ultimately outweighed pure economic calculus.

As a result, we have not yet seen significant supply chain disruption. Global supply chain pressures remain contained, and in the euro area, bottleneck indicators are close to historical averages.

If anything, rather than blocked supply chains, the euro area is facing rising imports. The euro area's trade deficit with China has risen by around 10% this year, although this was driven more by weaker Chinese demand than by diverted trade flows.

The exchange rate has also not behaved as expected.

Rather than depreciating, the euro has appreciated substantially. Since the start of this year, it has risen by 13% against the US dollar, while the nominal effective exchange rate has increased by 6.5% and the real effective exchange rate[4] by 5%.

This reflects the fact that the imposition of US tariffs coincided with a broader re-evaluation of the country's position in the global financial system.

Investors began to question whether the US dollar would continue to warrant its status as the ultimate safe-haven currency – another political-economy factor that narrow, tariff-focused models excluded by assumption.

The international role of the euro has helped insulate us from the resulting exchange rate volatility, with 52% of our imports invoiced in our own currency. But many key imports, especially commodities, are still priced in dollars.

The euro's appreciation has therefore contained imported inflation from supply chains, while at the same time placing an additional drag on growth.

The effects of uncertainty have been more in line with expectations. The expected cumulative impact of tariffs and uncertainty on growth is around 0.7 percentage points between 2025 and 2027, compared with our projections last December.

Still, these effects have not been as strong as we anticipated. For example, only about a quarter of the downward revision for next year, compared with December last year, is due to uncertainty.

This is partly because trade policy uncertainty fell faster than we expected once the deal with the United States was concluded. It is also because the euro area has taken internal measures to boost growth that have helped counter external weakness.

In particular, governments in Europe have committed to the largest increase in rearmament in decades, with some reversing years of underinvestment. Government investment is now expected to add 0.25 percentage points to growth[5] between 2025 and 2027, offsetting around one-third of the trade shock.[6]

The EU has also pushed ahead with new trade agreements, which will support growth. The Mercosur and Mexico deals now being adopted cover more than 3% of extra-euro area goods exports, while agreements currently under negotiation account for a further 6%.[7]

This is another example of a response that models could not capture beforehand: trade pressures have led European governments to re-evaluate their broader trade and security relationships, prompting an endogenous investment response.

All in all, with no retaliation and an appreciating exchange rate, tariffs have had little inflationary impact so far, with their adverse effects mainly limited to growth. Those effects, however, have been relatively moderate thanks to the domestic response.

Evaluating the balance of risks

In an environment of high uncertainty, understanding the nature of shocks is a precondition for getting the baseline projection right.

But capturing the balance of risks is just as crucial, so that we are prepared for a situation in which the baseline may prove obsolete and can act pre-emptively, if necessary.

This was a key conclusion of our recent strategy review: to emphasise more risks and uncertainty in our decisions, not just central projections.

Initially, we viewed the risks to growth from US tariffs as tilted to the downside.

This assessment was informed by extensive scenario analysis, including escalation scenarios and possible offsetting forces – notably the growth impact of a sustained increase in defence and infrastructure spending.

Overall, these scenarios have consistently shown that the most salient risks – those that could push growth furthest from its current path – lie on the downside rather than the upside.

For example, ECB staff find that severe escalation in trade tensions could lower growth cumulatively by about 1 percentage point over the projection horizon.[8] The potential boost from higher defence spending would not be sufficient to offset this, even if all countries were to deliver fully on their NATO commitments.

This tilt in the risk balance remains in place today. But at our last meeting, we judged risks to growth to be more balanced, because the likelihood of major tariff-related downside risks materialising had fallen owing to the new trade deal.

Meanwhile, we judged inflation risks to be two-sided, with plausible scenarios that could push inflation off track in either direction. But as new information has come in, the range of risks on both sides has also narrowed.

In particular, the absence of significant EU retaliation has reduced the risk that higher import tariffs might drive inflation above the baseline. Our scenario analysis also points to inflation risks that remain well contained.

If trade tensions were to reignite, staff project only moderately lower inflation in 2027, reflecting weaker growth. Higher spending on defence equipment, by contrast, would only modestly raise inflation, given its relatively small weight in the consumption basket.

Staff have also examined scenarios that would affect prices more directly: on the downside, Chinese export prices being lowered further as a strategic response to tariffs; and on the upside, more pronounced bottlenecks in global supply chains.

In both cases, however, the impact would be limited under reasonable assumptions, with inflation in 2027 differing by only 0.1-0.2 percentage points.[9]

Policy implications

So what does this imply for our monetary policy?

I have said that we are in a good place. This was largely a reference to the fading of the large inflation shock we faced in recent years, which is now essentially over in the euro area.

But there are also three additional reasons why it applies to the current situation.

First, because trade shocks are not creating new inflationary pressures, we are not confronted with the classic policy trade-off where the central bank faces stalling growth and rising inflation.

This has already allowed us to cut policy rates by 100 basis points since December – cushioning the impact while keeping medium-term inflation on track.

Second, insofar as we can model the future, the risks to inflation appear quite contained in both directions.

Third, with policy rates now at 2%, we are well placed to respond if the risks to inflation shift, or if new shocks emerge that threaten our target.

At the same time, we are navigating a far more difficult environment than before – beset by war, tariffs and uncertainty – which we must also factor into our policy.

If we consider the "known knowns", the risks appear well bounded.

But there are also "known unknowns" – above all, how euro area companies will adapt to this new setting. Firms are still running down inventories and absorbing the shock in margins, so the full effects of US tariffs have yet to become clear.[10]

Finally, there are the "unknown unknowns": in a world of geoeconomics, new trade and geopolitical shocks will remain a constant feature of our environment.

How these forces play out will have unavoidable effects on monetary policy – not only through their impact on growth, but also on potential growth.

If firms interpret the new environment as a lasting confidence shock, we could see investment shift out of the euro area.[11] Preliminary staff analysis suggests that, all else being equal, tariffs are likely to weigh negatively on potential growth.

Lower potential growth would, in turn, put downward pressure on real rates and reduce the policy space available.

But other paths are possible if governments act decisively and give firms new reasons to be confident.

One factor often overlooked in the tariff debate is that our internal market is far more important for trade than the global market. Staff analysis shows that an increase of just 2% in intra-euro area trade would be enough to offset the loss of exports to the United States caused by higher tariffs.[12]

This is a compelling reason to implement the reforms identified in recent reports from Mario Draghi and Enrico Letta, in particular simplifying burdensome regulation, completing the Single Market and building a genuine European capital market.

The same reforms would also help European companies adopt artificial intelligence more rapidly.[13] This would result in a positive shock for potential growth, helping to balance the negative forces coming from abroad.

In short, nothing about our future is fate – and there is no room for complacency by any party.

For our part, we cannot pre-commit to any future rate path, whether one of action or inaction. We must remain agile, and ready to respond to the data as they come in.

Conclusion

Let me conclude.

This is an unusual time to be a monetary policymaker.

We can take comfort in having overcome a large inflation shock after the pandemic, and in how the economy has coped so far with an upheaval in trade relations.

And yet, we must remain alert to the possibility that not all the consequences are visible today – and that new shocks may still lie ahead.

As we look to the future, we do so mindful of Finland's long tradition of *sisu* – courage and inner strength in the face of uncertainty.

Sisu is not a show of fleeting bravery, but rather a fierce determination and perseverance to continue fighting even when times get tough.

We are in a good place today, but that place is not fixed. Our task is to sustain it with agility, humility and a firm grounding in the data.

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[1] Analysis finds that the trade shock alone can explain between 4.7 and 5.9 percentage points of the loss in GDP. See Gulan, A. (2021), "Can large trade shocks cause crises? The case of the Finnish-Soviet trade collapse", *Blogs – Bank of Finland Bulletin*, Bank of Finland, 5 May.

[2] Gnocato, N. et al (2025), "Tariffs across the supply chain", *VoxEU Column*, CEPR, 30 May.

[3] Jouvanceau, V., Darracq Pariès, M., Dieppe, A. and Kockerols, T. (2025), "Trade wars and global spillovers. A quantitative assessment with ECB-global", *Working Paper Series*, No 3117, ECB, Frankfurt am Main, September.

[4] Deflated by consumer price inflation.

[5] This estimate also includes wages, government consumption and transfers.

[6] Government investment as a ratio to GDP is expected to be cumulatively almost 0.6 percentage points higher over the period from 2025 to 2027 than projected in December last year.

[7] With South Korea, India, Australia, Malaysia, Thailand, Indonesia and the Philippines.

[8] European Central Bank (2025), "Eurosystem staff macroeconomic projections for the euro area, June 2025", Frankfurt am Main, June.

[9] European Central Bank (2025), "Eurosystem staff macroeconomic projections for the euro area, September 2025", Frankfurt am Main, September.

[10] Organisation for Economic Cooperation and Development (2025), *OECD Economic Outlook Interim Report September 2025: Finding the Right Balance in Uncertain Times*, OECD Publishing, Paris, September.

[11] European Central Bank (2025), "The outlook for euro area business investment – findings from an ECB survey of large firms", *Economic Bulletin*, Issue 4.

[12] The United States accounts for 10% of total euro area exports, and the new tariffs are expected to reduce euro area exports to the United States by approximately 9%, translating to a 0.9% decline in overall euro area exports – roughly €66 billion. Making up for this shortfall in direct trade would require a 2% increase in intra-euro area trade.

[13] European Investment Bank (2025), *Investment Report 2024/2025: Innovation, integration and simplification in Europe*, March.