Monetary Policy

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How should monetary policy respond to tariffs? An explainer

Gavin Goy and Kostas Mavromatis

DeNederlandscheBank
EUROSYSTEEM

Content

Executive summary

The events of the past year underscore the importance of free trade for the global economy. Recent U.S. tariff increases on its trading partners have re-introduced significant uncertainty into the global economy. Although the immediate effects on U.S. inflation and activity have been limited — partly due to extensive front-loading of trade by firms and exemptions — the academic literature and model simulations suggest that tariffs ultimately raise U.S. consumer prices and reduce output.

For the euro area, higher U.S. tariffs are expected to be contractionary, primarily through reduced external demand. The inflationary impact is more uncertain. On the one hand, inflationary pressures may arise if European firms absorb part of the tariffs on the goods they export to the US, passing higher global costs to domestic consumers or if they face higher input costs due to rearrangements of global value chains. On the other hand, the appreciation of the euro's effective exchange rate in 2025 has a disinflationary effect, reinforced by trade diversion: as U.S. tariffs on the rest of the world have increased more steeply, European markets have absorbed a larger share of diverted imports—particularly from China—placing downward pressure on import prices and domestic producer prices.

Retaliation by the EU would worsen the macroeconomic outlook. Model simulations show that an increase of EU import tariffs in response to higher U.S. tariffs deepens the decline in GDP on both sides of the Atlantic and ultimately depresses inflation via weaker aggregate demand. This provides analytical support for the EU's restrained stance so far, even if the analysis does not account for political-economy considerations.

The academic literature suggests that, provided inflation expectations remain anchored, the optimal monetary policy response to tariffs in the imposing country. is rather accommodative, thus looking through the gradual tariff-induced increase in prices and accommodating the resulting weakness in real activity. The rationale is that tariff shocks reduce real income and distort trade in ways that tighten financial conditions and suppress demand. Tightening policy in response to tariff-induced rise in prices would amplify these recessionary effects without materially improving medium-term price stability. However, if anchoring came at risk, the literature suggests a sharp pivot to a more restrictive monetary policy.

For the ECB, the ultimate impact of U.S. tariffs on euro area inflation cannot be assessed ex ante, given that it depends on conflicting forces from demand and supply, exchange rate movements, and elevated trade policy uncertainty. In the short term, the fact that the euro appreciated rather than depreciated—together with evidence of rising trade diversion—suggests that (mild) disinflationary

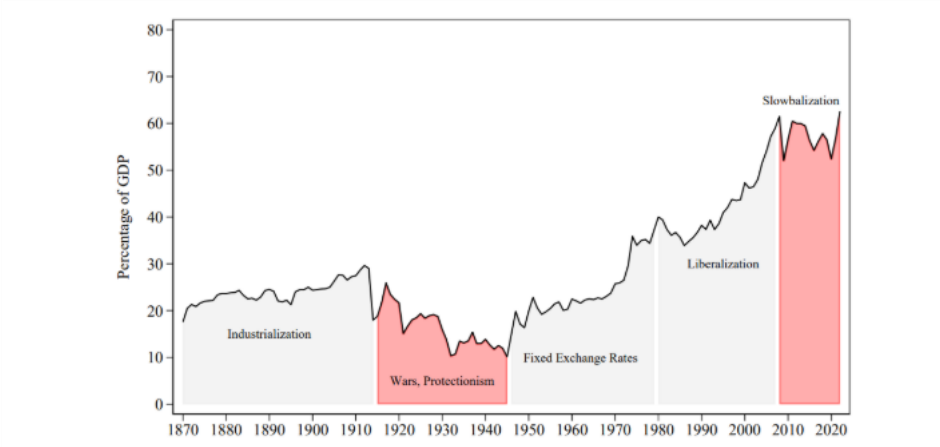
pressures might dominate. In the longer term, a shift toward a more fragmented global economy could create sustained upward pressure on inflation. Fragmented supply chains, higher trade barriers, and restricted access to critical materials may over time raise import costs and reduce productive capacity, leading firms to rely more on costlier domestic production. However, weaker productivity, lower real income growth, and elevated geopolitical uncertainty could dampen aggregate demand through delayed investment and cautious consumer spending. The net long-term inflation outcome will depend on how these opposing supply- and demand-side forces interact

Against this backdrop of heightened uncertainty, the ECB should continue its data-dependent, meeting-to-meeting approach. This allows policymakers to monitor how exchange rates, trade patterns, and global demand evolve over time and to respond flexibly if tariff-driven shocks threaten to undermine in either direction the inflation outlook or economic activity.

1. Introduction[1]

Global trade steadily increased during the second half of the 20th century but has flatlined since the global financial crisis. Since the 1950s, global trade has seen rapid growth amid a continued reduction in trade barriers and rising trade liberalization. **Chart 1** shows that global imports and exports over GDP have risen from below 20% to around 60% before the global financial crisis. Since then, a myriad of both cyclical and structural factors has limited global trade (see Gregori (2021) for an overview), including increased protectionist measures such as discrimination and tariffs.

Chart 1: Decade-long rise in global trade has stopped



Source: Ambrosino et al. (2025). *Note*: Global imports and exports over GDP in percentage points.

The US administration's trade policies initially created significant uncertainty regarding the magnitude of tariffs and possible retaliatory measures. Under the new administration of President Trump, the United States initiated a sweeping round of tariffs on imports from several key trading partners, including the euro area.[2] The initial ambiguity surrounding the level, timing and duration of these tariffs as well as the responses they trigger unsettled global markets and strained transatlantic and transpacific economic relations. However, after a period of heightened tension and negotiation, the U.S. and the European Union ultimately reached a deal on July 27, 2025, signaling a move toward de-escalation and renewed cooperation in trade matters, albeit with a rise in effective U.S. tariffs.[3] On February 20th, the US Supreme Court ruled part of Trump's new

[1] We thank Guido Ascari, Jan Willem van den End, Gabriele Galati, Niels Gilbert, Stephen Kho, Tjerk Kroes and Jurrien van de Wiel for useful comments and discussion.
[2] To this day, the U.S. administration has rolled back duties on several imported goods amid concerns over their impact on the cost of living of American households. Albeit a positive impact on sentiment, this adds to the uncertainty about the level, timing and duration of tariffs.
[3] On January 21, 2026, the European parliament suspended the approval of the US trade deal considering the rising geopolitical uncertainty.

tariffs illegal. Immediately after the ruling, President Trump announced new tariffs, based on a different set of laws. At the time of the writing of this analysis, the real impact of the ruling therefore remains unclear, even if uncertainty has clearly rebounded.

This DNB Analysis discusses the macroeconomic effects of tariffs and their implications for monetary policy based on the latest academic literature. In our analysis, we proceed in three steps. To set the scene, we first sketch the expected effects of tariffs and possible retaliation measures, using the U.S. and euro area as an example. We also contrast the textbook predictions with the findings of recent empirical literature. Simulations based on a multi-region dynamic general equilibrium model further help to understand the effects of U.S. tariffs. We then demarcate these simulations with the observed macroeconomic effects to date. Subsequently, we review the 'optimal' monetary policy response for both the U.S. and euro area based on the recent academic literature, with the aim of distilling some policy recommendations for the ECB.

2. Sketching the problem for policymakers

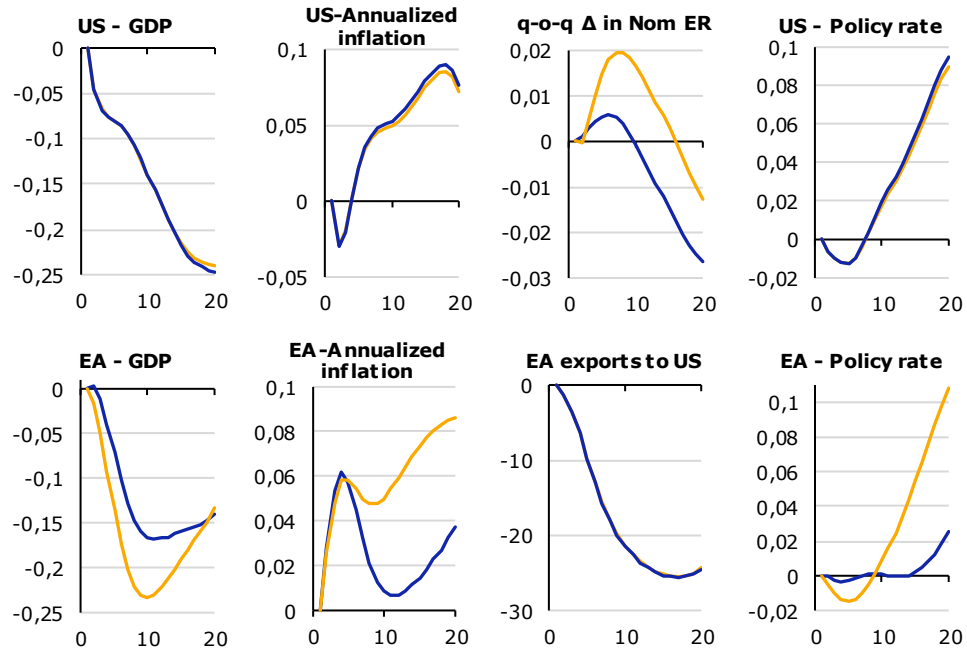
2.1 The effect on the tariff-imposing country

The first-order effect of tariffs is to make imported goods more expensive in the imposing country. For the imposing country, tariffs are often referred to as a "*tax on consumers*", as increased import prices will largely be passed on to final consumers, eventually increasing inflation. This is also confirmed by a recent study from Gopinath and Neiman (2026), who confirm that the tariff pass-through to U.S. import prices is almost 100 percent. Additionally, for imported intermediate goods, tariffs disrupt production networks. The conventional view therefore suggests that tariffs lead to lower productivity, a duplication of production capacities, which increases production costs and, ultimately, exerts upward pressure on inflation. To date, the empirical literature has provided mixed evidence of these channels. Looking at the U.S. postwar period, Schmidt-Grohe and Uribe (2025) indeed find a temporary increase in inflation following a permanent increase in tariffs, consistent with higher import prices being passed through to consumers. Also, Boer and Rieth (2024) and Franconi and Hack (2025) find that tariff shocks raise consumer prices, with the latter study pointing to substantially delayed effects of tariffs on prices. Contrary to those findings, Den Besten and Kanzig (2025) and Barnichon and Singh (2025) find some evidence for falling prices (at least post-world-war-II) as tariff hikes are contractionary and lead to higher unemployment. Both studies use annual data stretching over a century. Consequently, those analyses find evidence for the adverse demand side effects of tariffs to have outweighed the first-order inflationary supply side effects in the long-run.

Tariffs disrupt production networks, lower productivity and ultimately output. Protectionist measures such as tariffs often aim to protect or revive domestic industries by reducing their prices relative to those of international competitors. For goods that are (fully or partly) substitutable, higher prices for imported goods may increase demand for domestically produced goods. For instance, higher U.S. price for French wine may lead to a higher demand for U.S. wine, thus increasing the market share of domestically produced goods. But not all goods are substitutable or are produced (as efficiently) domestically. Bianchi and Coulibaly (2025) therefore, argue that tariffs induce inefficiently low imports. The U.S. car industry is a prime example in which tariffs can cause more harm than good, as many intermediate goods are produced outside the U.S. and may cross the border several times before the final assembly. These disruptions become larger the less substitutable the intermediate goods are, or the more global production networks are (Bergin and Corsetti, 2023). Accounting for such intermediate input trade, Auclert et al (2025) show that tariffs are mostly recessionary, even if they improve the trade balance. Ambrosino et al. (2025) attribute the contractionary

effects of higher import prices to the resulting aggregate demand effects: lower productivity squeezes firm profits, and the inflationary effect further lowers real incomes, both of which depress consumption. Finally, Monacelli (2025) argues that the effects of import tariffs depend crucially on the reaction of monetary policy: in response to the rise in inflation, monetary policy generally raises interest rates which further dampens economic activity.

Chart 2: U.S. tariffs act as cost-push shock in the U.S., while euro area effects depend on the exchange rate



Sources: DNB calculations. *Note*: Horizontal axis depicts quarters. U.S. and euro area macroeconomic impulse responses to a unilateral 15 percentage point increase in U.S. import tariffs on euro area. Blue (yellow) lines assume a high (low) sensitivity of the exchange rate to frictions in international financial markets. The simulations are based on the EAGLE model, a four-region DSGE model. Tariff revenues in each region are collected to service government debt. The nominal exchange rate depicts the euro price of a dollar; a decline therefore reflects an appreciation of the euro. Simulations exclude effects of trade uncertainty.

The combination of higher prices and lower activity in the tariffs-imposing country creates a trade-off for domestic monetary policy (Werning et al., 2025). Simulations of U.S. tariffs on euro area imports using a multi-country model confirm this finding (both lines in **Chart 2**). According to the model, an across-the-board 15 percentage points increase in U.S. tariffs on euro area imports raises U.S. inflation by almost 0.1 percentage points in the medium term[4], while real GDP falls by a quarter percentage point over the next five years. In the model, the muted

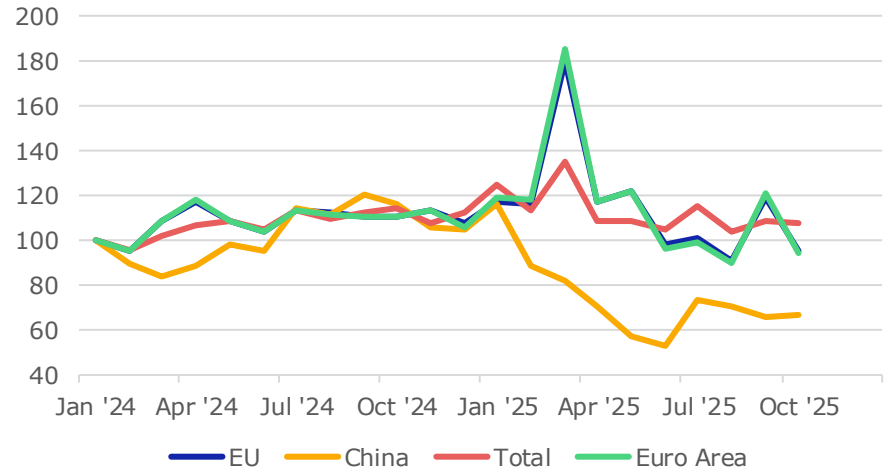
[4] These estimates are close to those of Alvarez & Yilmazkuday (2025) who find a tariff pass-through to inflation of about 9% in the U.S. based on an estimated dynamic general equilibrium model.

impact on inflation is attributed to high price stickiness that affects not only the pass through of tariffs on final goods prices, but also the exchange rate passed through. Also note that this hypothetical scenario considers higher U.S. import tariffs *only* on euro area imports, not on those of other trading partners.[5] For monetary policy, the combination of higher prices and lower economic activity creates a trade-off. Stabilizing inflation requires higher interest rates. In contrast, lower economic activity suggests the opposite, even under a pure price stability mandate, as lower economic activity will eventually lead to lower inflation in the medium term. On balance, our simulations point to a modest increase in U.S. interest rates by about 10 basis points within five years. All in all, our simulations point to stronger adverse effects of tariffs on economic activity in the US than on inflation. However, it is important to highlight that long-term inflation expectations are always anchored in the model. This limits the risk that a temporary increase in inflation becomes entrenched and consequently eases the trade-off between growth and inflation for monetary policy makers.

The inflationary effects of the 2025 tariff hikes have been limited to date due to several factors, but pass-through to import prices was almost complete. In anticipation of higher import tariffs, U.S. firms have front-loaded imports, stockpiling large amounts of inventories. As a result, U.S. imports surged in the first quarter of 2025 prior to the April 2 announcement (**Chart 3**), dampening the initial effect on firms' cost. According to Gopinath and Neiman (2026), "*shipping lags, exemptions, and enforcement gaps have kept the actual implemented rates at only half of the statutory rates, moderating the tariffs' impact*". Additionally, some firms might have been reluctant to pass higher costs entirely on the U.S. consumers. This leaves room for uncertainty about whether and when the pass-through of higher tariffs to inflation will materialize. Former IMF chief economist Gita Gopinath therefore recently warned that "*[t]he damage from tariffs will grow more visible in 2026 as the resilience afforded by frontloaded imports fades and companies pass through a higher share of costs to cons*umers".[6] Indeed, in her joint study with Neiman, she finds that the pass-through of (the actually imposed) tariffs to U.S. import prices is almost 100 percent, concluding that the United States is bearing a large share of the costs.

[5] Simulations with higher tariffs on all the U.S. trading partners are considered in Section 2.4.
[6] "Don't be fooled — everything has changed for the global economy", Financial Times, on January 7, 2026 by Gita Gopinath.

Chart 3: U.S. imports from different regions



Source: Refinitiv. *Note*: Imports in nominal value. Normalized to 100 in January 2024.

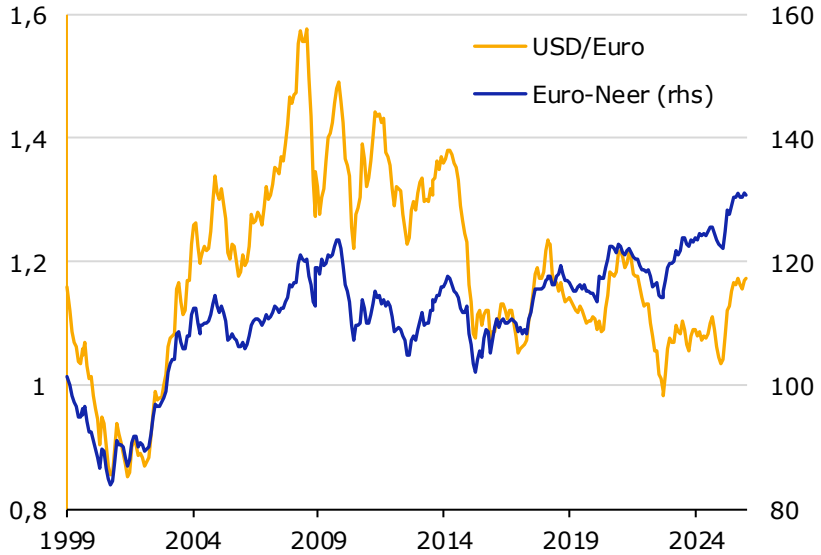
2.2 The effect on the exporting country

For the exporting country, tariffs imply reduced external demand and are therefore contractionary. As a result, firm profits in the export sector of the trade partner are squeezed, leading to a decline in employment and investment in that sector in response to the fall in revenues. The lower demand for labor in the sectors hit by U.S. tariffs exerts downward pressures on the corresponding real wages which, in turn, gives rise to negative second round demand effects of tariffs. Consistent with this, simulations in **Chart 2** (both lines) show that GDP in the euro area declines by more than 0.15 percentage points following the unilateral increase in U.S. tariffs.

The global structure of European production networks may pose upward risks to euro area inflation. These inflationary pressures can come from two sources. First, euro area firms that rely on U.S. intermediate goods as imports themselves, may see higher input costs because of the U.S. tariffs, which they in turn may pass on to consumers. Second, some euro area firms may choose to partially absorb U.S. tariffs in fight for market shares. In this case, they may pass some of the costs on the prices they charge domestically, leading to higher inflation in the euro area. Our model captures this channel. In both scenarios considered in **Chart 2**, inflation in the euro area rises partly due to domestic firms passing on the

impact of tariffs on their costs to domestic households.[7] The stronger the appreciation of the euro, though, the weaker this channel becomes.

Chart 4: Euro dollar exchange rate and Euro nominal effective exchange rate



Sources: ECB Statistical Data Warehouse. *Note*: The monthly nominal spot exchange rate is defined as dollars per euro. The nominal effective exchange rate uses 40 trade partners with fixed and a rise corresponds to an appreciation of the euro vis a vis a basket of currencies.

The overall net impact on euro area inflation also depends, among others, on the pass-through of the bilateral exchange rate to prices, with the euro appreciation dampening any inflationary pressures. Conventional wisdom suggests that the euro would depreciate following the imposition of U.S. tariffs, given the lower demand for euro area goods and the relatively more restrictive U.S. monetary policy. This is also suggested by the yellow simulations yellow in **Chart 2**, where the euro depreciates persistently amid the increase in U.S. policy rates. During 2025, however — and contrary to conventional wisdom — the euro has appreciated approximately 13 percentage points to 1.18 dollars per euro, close to its long-term average since 1999 (see **Chart 4**). The recent appreciation may also reflect market expectations that the new chair of the Federal Reserve will implement a more accommodative monetary policy stance. To account for this observation, the blue solid line – our baseline simulation – in **Chart 2** presents simulations in which foreign holdings of U.S. assets are relatively less attractive, resulting in a mild and short-lived depreciation of the euro followed by a persistent

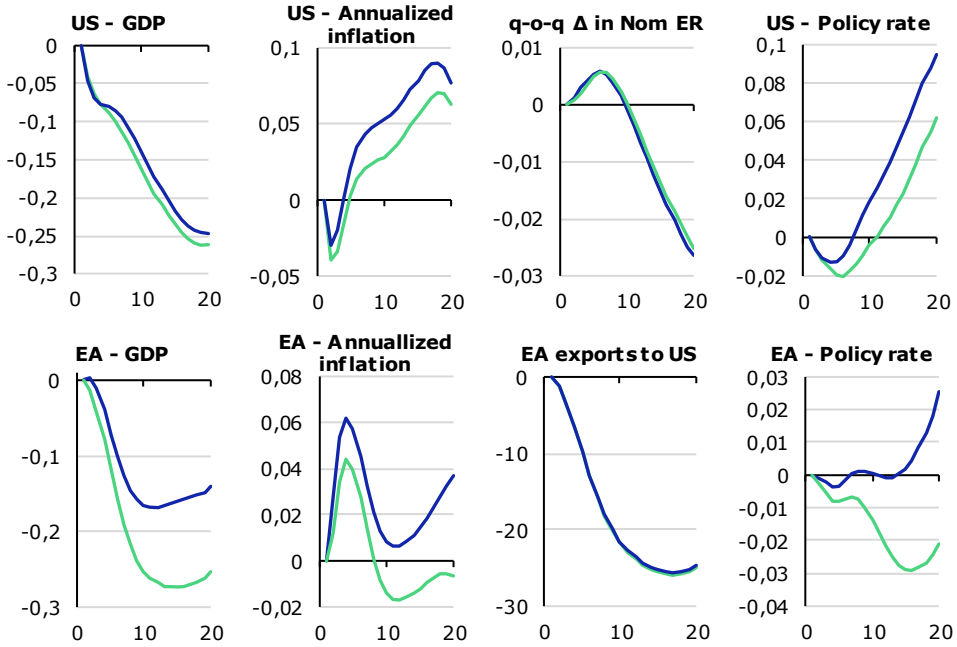
[7] In her speech in Dubrovnik on June 7, 2025, ECB executive board member, Isabel Schnabel suggested that tariff-driven cost increases ripple through global supply networks, elevating producer prices and ultimately feeding into consumer inflation in the euro area. As such, tariffs —even without retaliation—can be inflationary. Moreover, according to Auer et al. (2019), a 1% rise in global producer prices could raise domestic inflation by 0.2%

appreciation in the medium term. The stronger euro, in turn, reduces costs for imports in the euro area, thus damping the response of inflation.

2.3 The effects of retaliation

Retaliatory measures aggravate the economic downturn at home and abroad. Many of America's trade partners have been reluctant to retaliate due to fears of triggering a full-scale trade war. But, for the domestic economy, retaliation also adds the negative effects of imposing tariffs mentioned above: by raising import prices, retaliation raises costs for domestic firms and hurts private consumption. As a result, investment decisions are held back and employment declines further, exacerbating the adverse effects on economic activity coming from lower external demand. This intuition is confirmed in our simulations of a hypothetical scenario in which the EU retaliates by, in turn, levying 10% tariffs on U.S. imports. **Chart 5** compares the unilateral tariff scenario from above (blue solid) with a retaliation scenario (green lines). The decline in euro area GDP almost doubles after ten quarters, with the decline in aggregate demand also outweighing the inflationary impulse from the tariffs in the medium term. These results provide some analytical backing of the EU's hesitation to retaliate to the initial announcement of higher U.S. import tariffs.

Chart 5: Euro area retaliation in response to unilateral U.S. tariffs worsens the decline in GDP which weighs on inflation



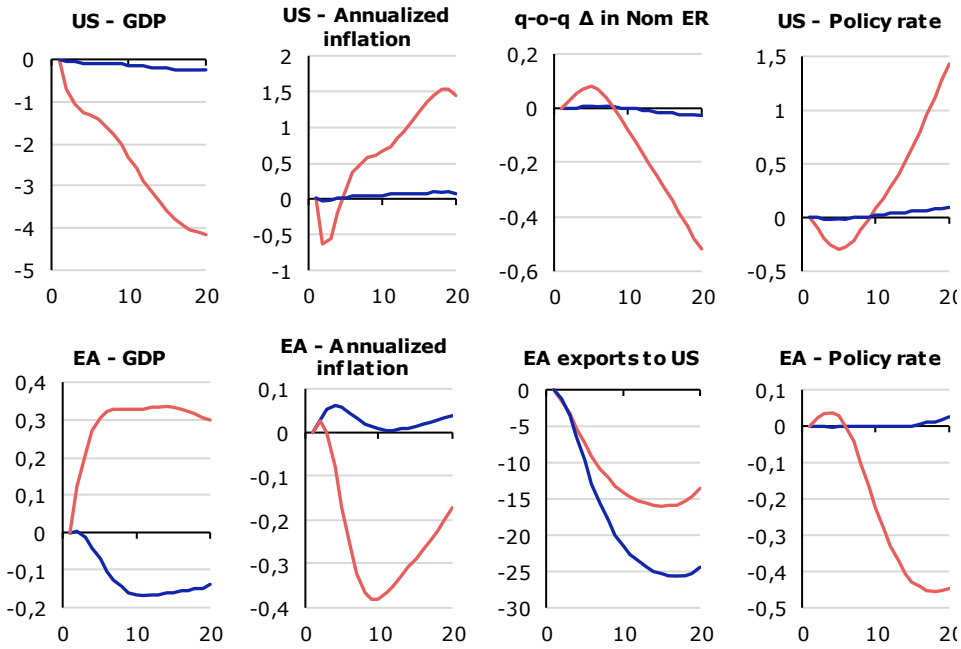
Sources: DNB calculations. *Note*: Horizontal axis depicts quarters. Blue lines show the responses to a unilateral increase in U.S. import tariffs on euro area by 15 percentage points. Green lines show the case in which the euro area retaliates also raising tariffs by 10 percentage points. Exchange rate sensitivity to net external debt is high in both cases. Simulations are based on the EAGLE model, a four-region DSGE model. Tariff revenues in each region are collected to service government debt. The nominal exchange rate depicts the euro price of a dollar; a decline therefore reflects an appreciation of the euro. The simulations exclude effects of trade uncertainty.

2.4 Trade diversion

Differences in U.S. tariffs on its trading partners may cause diversion of trade flows, with the European Union likely among the main absorbers. A natural consequence of the steeper increase of U.S. tariffs on some regions is trade diversion of exports of the hardest hit countries to non-U.S. markets. **Chart 6** compares the case in which the U.S. raises tariffs by 15 percentage points to imports from the EU alone (blue lines) against the case in which it also raises tariffs by 50 percentage points on imports from the rest of the world (red lines). This is meant to capture the fact that countries like Brazil, China and India saw (partly temporarily) larger increases in effective tariffs. The simulations offer a few important insights. First, for the U.S., the inflationary nature of the shock becomes much larger, with inflation rising to 1.5 percentage points in the medium run despite a significant tightening of monetary policy, which depresses real GDP around 4 percentage points after five years. Second, the relatively larger increase in tariffs on the rest of the world eases the negative demand effects from the U.S.

tariffs on euro area imports, with euro area exports to the U.S. declining by only 15 percentage points instead of 25 percentage points. Third, for the euro area, the rise in effective U.S. tariffs on the rest of the world results in an abrupt rise in imports from those regions. This is consistent with the sharp decline in Chinese exports to the U.S. of almost 30% (**Chart 3**) and a concomitant increase in EU imports from China by ca. 15% in nominal terms (U.S. dollars) in the first half of 2025 relative to the first half of 2024 (**Chart 7**). Fourth, the increase in the supply of imported goods from the rest of world entails downward pressures on imported goods inflation and a deterioration of euro area firms' competitiveness domestically. Those eventualities create deflationary pressures in the euro area with headline inflation declining by 0.4 percentage points approximately within a two-year horizon.[8] The commensurate easing of euro area monetary policy, in turn, leads to a small expansion in economic activity with real GDP increasing by about 0.3 percentage points.

Chart 6: Higher U.S. tariffs on other trading partners causes trade diversion into the euro area



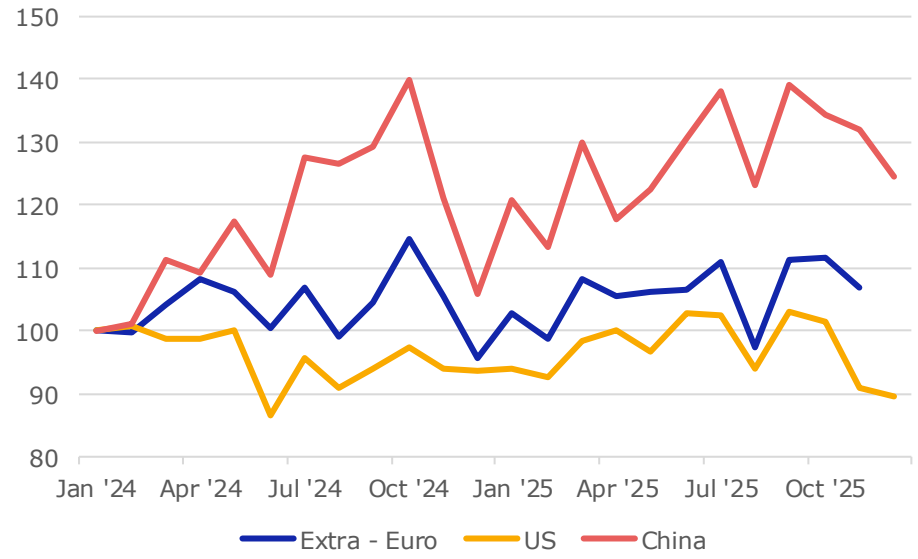
Sources: DNB calculations. *Note*: Horizontal axis depicts quarters. Blue lines show the responses to a unilateral increase in U.S. import tariffs on euro area by 15 percentage points. Red lines show the case in which the U.S. also raises tariffs by 50 percentage points on the rest of the world. Exchange sensitivity to net external debt is high in both cases. Simulations are based on the EAGLE model, a four-region DSGE model. Tariff revenues in each region are collected to service government debt. The nominal exchange rate depicts the euro price of a dollar; a decline therefore reflects an appreciation of the euro. The simulations exclude effects of trade uncertainty.

[8] A recent ECB blog by Boeckelmann, Emter, Gunnella, Klieber and Spital finds similar albeit somewhat lower effects, with euro area inflation declining by 0.15 percentage points.

2.5 The role of uncertainty

Uncertainty surrounding trade policy adds to the drag on economic growth. The economic literature generally agrees that uncertainty is detrimental for economic activity. For instance, Bloom (2009) demonstrates that an unexpected rise in uncertainty lead to sharp declines in economic activity because firms tend to delay irreversible decisions—such as capital investment or hiring—until uncertainty resolves.[9] Bloom (2014) further emphasizes how this wait-and-see behavior amplifies the economic impact of uncertainty. Cesa-Bianchi et al. (2020) extend this analysis to an international context, showing that global uncertainty shocks propagate across borders and depress output, particularly in emerging markets. In the context of trade policy uncertainty (TPU), Caldara et al. (2020) construct a novel index capturing uncertainty about the implementation and the variation of tariffs based on U.S. newspapers appearances. They find a rise in TPU to lead to a decline in investment and to a contraction in economic activity. Considering this literature, the elevated uncertainty around trade policy triggered by the current U.S. administration—characterized by abrupt tariff changes, shifting trade alliances, and inconsistent communication—can be expected to exert a chilling effect on economic activity. Such policy volatility increases uncertainty for firms engaged in global value chains, likely leading to postponed investment decisions, reduced cross-border trade, and slower overall growth, both domestically and internationally.

Chart 7: Euro area imports



Sources: Eurostat. *Notes*: Import volumes, normalized to 100 in January 2024.

[9] See also ECB Economic Bulletin Issues 3 and Issue 5, 2025, on the impact of trade policy and geopolitical uncertainty on firms' investment decisions and economic activity.

2.6 Possible long-term effects of supply chain disruptions and re-sourcing

The transition to a more fragmented global economy could create longer-term inflationary pressures, but overall effect remains uncertain. More fragmented global supply chains, either through higher tariffs, other trade barriers, or a curtailed supply of critical raw materials could add to capacity constraints in the euro area economy and push up import prices. In the long term, these forces may create structural inflationary pressures as domestic firms shift away from cheaper foreign suppliers and re-shore part of the production. While there is little empirical evidence of a significant inflationary impact from de-globalization to date (Ilkova et al., 2024), the effects may build up more slowly. Clancy et al. (2024) show such an adjustment could increase inflation persistently in the medium term. This is also consistent with model-based simulations by Attinasi et al. (2025), although the impact depends on the assumptions about the scope and magnitude of the increase in trade barriers. That said, the overall implications though for inflation in the longer term also depend on how aggregate demand adjusts in the face of lower productivity and real income growth. Persistently high geopolitical and trade uncertainty can cause delays in investment decisions while at the same time precautionary motives by consumers may exert downward pressure on private consumption. These effects can trigger downside risks to aggregate demand working in the opposite direction — as regards the impact on long-term inflation — to those on the supply side described above. It is the interaction thus between supply and demand forces that will determine whether the long-term risks to inflation are balanced or skewed towards a certain direction.

3. Optimal monetary policy response to tariffs

If import tariffs lead to a *temporary* increase in inflation, monetary policy of the tariff-imposing country can look through the temporary rise in prices and accommodate the real economy. A growing number of academic papers have studied the 'optimal', i.e. welfare maximizing, monetary policy response to tariffs. The answer to this question is a priori unclear, because—as mentioned above—tariffs create a trade-off for central banks between output and inflation stabilization (Werning et al., 2025). Bergin and Corsetti (2023) argue that the global value chain disruptions and sectoral reallocations render demand support essential even if headline inflation rises temporarily. Similarly, Bianchi and Coulibaly (2025) contend that tariffs induce inefficiently low imports because agents ignore tariff revenue's income effect; by easing monetary policy, the domestic currency depreciates and therefore mitigates this distortion. Across these channels—cost-push inflation, reduced real income, and trade distortions—the consensus in the literature is that a relatively expansionary monetary policy helps smooth the transition and sustain output, even if it tolerates temporarily higher inflation.

A similar policy prescription applies if tariffs set abroad cause domestic inflation to rise temporarily. While the academic literature has largely focused on how the Federal Reserve should optimally respond to the increase in U.S. import tariffs, the question is obviously equally relevant for U.S. trading partners who see higher tariffs on their U.S.-bound exports. To guide policymakers, Hamano et al. (2023) study the optimal monetary policy response to an unexpected increase in foreign tariffs. According to their results, the rise in foreign tariffs is also inflationary domestically, mostly through the exchange rate channel. This is consistent with the simulations shown in Chart 2, which suggest that euro area inflation rises temporarily in response to U.S. tariffs. Hamano et al. (2023) then show that optimal monetary policy should look through this temporary rise in inflation, leaving interest rates lower than they would otherwise be to cushion the negative demand effects. The simulations presented above convey a similar message, suggesting at most a mild rise in the policy rate in the euro area. A persistent appreciation of the euro would strengthen the case for an accommodative response.

But monetary policy needs to react decisively if inflationary pressures turn out to be more persistent. The model simulations and studies discussed above all foresee only a temporary or mild rise in inflation to a one-off increase in U.S. import tariffs. They also assume long-term inflation expectations to be anchored. If, however, this process of geopolitical fragmentation was to continue, structurally higher inflationary pressures could arise in the medium to long-term that could render the initial increase in inflation more persistent. Beaudry et al. (2023) show that, when inflation becomes entrenched and inflation expectations de-anchor from

the central bank's target following an unexpectedly persistent supply shock, optimal monetary policy pivots aggressively from initially looking through the supply shock to a more restrictive, anti-inflationary policy stance. Ensuring price stability therefore requires a decisive monetary policy response and a close monitoring of (long-term) inflation expectations.

4. What does this imply for the policy response of the ECB?

How the increase in U.S. tariffs on its trading partners ultimately affects euro area inflation is ex ante unclear amid many counteracting factors. According to most studies, the unilateral increase in tariffs leads to a decline in economic activity and a temporary rise in euro area inflation on the back of a depreciation of the euro. Yet many factors, including differences in the size of U.S. tariffs on its trading partners, possible trade diversion, the timing and degree of front-loading by U.S. firms, the price pass-through of global firms, as well as the effect of trade policy uncertainty may all strengthen or weaken the counteracting demand and supply effects that affect euro area inflation. As a result, the effect of U.S. import tariffs on euro area inflation is ex ante unclear.

The appreciation of the euro since the start of the year, especially vis-à-vis its trading partners, mitigates any inflationary effects, with no trade-off for monetary policy. While the appreciation of the euro against the U.S. dollar since early 2025 has resulted in a bilateral rate that is fluctuating close to its historical average, it appreciated considerably over the course of last year against a basket of currencies of its trade partners. The appreciation of the euro is likely to dampen inflation by decreasing the prices of imported goods[10], while lower competitiveness of euro area exporters reduces external demand, creating a potential drag on economic activity in the euro area. Viewed in isolation, this would call for an easing of the monetary stance relative to the hypothetical scenario of no tariffs.

As the macroeconomic effects of tariffs are highly uncertain, the ECB should remain data-dependent and continue with its flexible meeting-to-meeting approach. According to the academic literature, 'optimal' monetary policy should look through a temporary increase in inflation and focus on accommodating the negative demand effects from the increase in tariffs. As we have laid on in this analysis, the exact effects of higher U.S. tariffs on the euro area economy, and inflation in particular, are difficult to assess ex ante. This holds both in the short- and long-term. In light of the heightened uncertainty and two-sided risks to inflation, monetary policy needs to be flexible, as called for by the former DNB president Knot in a speech in Utrecht in 2025.[11] Consequently, the ECB is best advised to adhere to its data-dependent, meeting-to-meeting approach to assess how the risks to the euro area economy unfold and ensure that long-term inflation expectations remain anchored at the ECB's 2% inflation target.

[10] See the report of the expert group on exchange rate pass through in the euro area.
[11] See Knot, "Monetair beleid in tijden van grote onzekerheid" (in Dutch), 28 May, 2025, Utrecht.

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