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Institutions, Anchors, and Their Discontents: The Role of Central Banks - Speech by Governor Gabriel Makhlouf to Blavatnik School of Government

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It is a pleasure to be here in Oxford¹ While I'm aware that this is a school of government and I'm a central banker, the two are inextricably linked. Societies and indeed economies are shaped by their institutions, specifically the legal, social, cultural, formal and informal norms that impact the way citizens interact with each other. Successful institutions are those that are trusted by the societies that created them and for which they ultimately serve.

Today I am going to resist the opportunity to deliver a lecture on institutional economics. I will instead concentrate on central banks as institutions, their mandates, the way they deliver their responsibilities, the way they hold themselves accountable and some of the challenges ahead.

It is not a particular surprise that central banking finds itself in the news. In the normal course of events, decisions taken and judgements exercised by central banks affect economies and financial systems in individual countries and across the world. What has been relatively recent, at least in advanced economies, is the resurfacing of questions around the independence of central banks, in

some countries at least. I want to approach this subject not as a defence of technocracy, but as a reflection on institutional design: why certain arrangements persist, why others fail and why independence, properly understood, has become a defining feature of modern monetary frameworks.

Institutions

Let me begin by briefly considering institutions more broadly.

A large and influential body of economic research shows that institutions matter profoundly for long run economic performance.

Ronald Coase taught us that well-designed institutions reduce transaction costs and enable complex economic organisation. Yet, in his Nobel speech in 1991, he also remarked how institutions within economic systems can sometimes feel so obvious as to be overlooked; part of the background tends to get ignored.² Sometimes we need to remind ourselves of their importance so that their value is not eroded.

Douglass North showed how credible rules and constraints shape incentives and economic outcomes over time.³ While Elinor Ostrom demonstrated that carefully designed governance arrangements can sustain cooperation even when interests diverge and information is incomplete.⁴ More recently, Acemoglu and Robinson have argued that inclusive and credible institutions are a prerequisite for sustainable prosperity.⁵

The common thread in this research is not that well-designed institutions guarantee success but rather they are the building blocks upon which that economic success is built. Institutions shape expectations, discipline behaviour, and determine whether commitments are believed. Institutions influence whether policies are credible and whether short term pressures overwhelm long term objectives.

Central banking

Central banking should be understood through this institutional lens.

While central banks date back to the founding of the Sveriges Riksbank in 1668, mandated independent central banks are a relatively recent development. Central banks' functions and activities have evolved over centuries, in line with the growing sophistication of the financial system and our understanding of monetary policy. They are the product of experience, theory, and, sadly, past policy failure. Their purpose is to support a stable and sustainable macroeconomic framework, to the net benefit of society at large.

Successful economies are characterised by stable and predictable prices, prudent fiscal policy, sustainable public finances, well-regulated financial systems, and well-functioning markets.⁶ Central bank independence is one of the institutional foundations that makes such a framework credible and durable.

Independence is sometimes portrayed as a shield. I see it more like an anchor providing stability, while also allowing for some movement and flexibility when required. Importantly, it gives central banks the confidence to take difficult decisions, drawing on different perspectives and sometimes longer horizons.

Independence is not an end in and of itself. It is an institutional tool, delegated by elected legislatures, to enable central banks to serve the public interest.

The value of that tool lies in credibility. As many economists have noted, credibility is the central bank's most valuable asset.⁷ It allows central banks to act when action is least convenient politically but most necessary economically. But credibility is not generated by distance alone. It also depends on a number of elements including competence, engagement, coherence, and trust that decisions will be taken consistently within the mandate and in-line with the long-term interests of the people.

These issues are particularly salient today. Following a period of elevated inflation and rapid monetary tightening, central banks face heightened scrutiny. Interest rates have entered mainstream political discourse, with some questioning whether decisions should be based solely on economic fundamentals. As I mentioned earlier, the debate around central bank independence has resurfaced in some parts of the world. It is a reminder that independence can neither be assumed, nor is it self-sustaining. There is no "natural law of central bank independence". Rather it must be explained, understood and earned continuously if it is to be sustained.

Why does independence and credibility matter? Thankfully, or not for those who had to live through it, we have plenty of historical experiences to show us why.

The macroeconomic record of the nineteen sixties and seventies provides a clear counterfactual. During this period, monetary policy was often subject to short term political pressures. Inflation became persistently high. Inflation expectations were poorly anchored. Macroeconomic volatility increased.

The theoretical explanation for this experience is well established. Research has demonstrated that discretionary policy without credible commitment is vulnerable to time inconsistency even when policymakers are well intentioned.⁸ Barro and Gordon formalised the inflation bias that arises when policymakers face incentives to pursue short run output gains.⁹ Rogoff showed how delegating policy to a “conservative” central banker – in the sense that they care about inflation more than the average citizen, could improve welfare by reducing that bias while preserving stabilisation capacity.¹⁰

The shift in the early nineteen eighties marked a turning point. Under Paul Volcker’s leadership, the Federal Reserve prioritised price stability despite intense political and social pressure. Reflecting on his time as Fed Chair, Volcker argued that restoring credibility required resisting short term expediency in order to secure long term stability.¹¹ The monetary policy actions to re-anchor inflation expectations were, ultimately, necessary, but very costly from the perspective of the economy, businesses and households. Compare that to the inflation spike following Covid. Central banks were in a position to act decisively and relatively quickly to bring inflation down to target, while avoiding a recession. The credibility that had been built up over time underpinned the effectiveness of that response, reducing its ultimate costs.

Europe during the 1970s and 1980s was certainly no bastion of prudent monetary policy either. Central bank mandates varied and their independence was either weak or non-existent. In Italy during the 1970s and early 1980s, the central bank was required to engage in government financing, contributing to persistently high inflation and exchange rate instability (one of the main reasons from the 1981 “divorce” reforms that granted the Banca d’Italia independence in conducting monetary policy).¹² In the United Kingdom prior to 1997, interest rates were set by the Chancellor of the Exchequer, including during the turbulent period leading up to Sterling’s withdrawal from the Exchange Rate Mechanism in 1992.¹³

The response was institutional reform.

For Ireland, monetary policy independence is exercised through the Eurosystem: I participate in the ECB’s Governing Council, whose mandate and independence are set out in EU law and the Statute of the European Central Bank. Otmar Issing has described this framework as a deliberate attempt to insulate monetary policy from fiscal dominance while anchoring it in a clear price stability mandate.¹⁴ Accountability is exercised through the European Parliament and, nationally, through the Oireachtas, Ireland’s Parliament, and formal reporting obligations. In the United Kingdom, operational independence was granted to the Bank of England through legislation, with objectives defined by government and implementation delegated to the central bank.

These frameworks differ in design, reflecting national preferences and histories. But they share common fundamentals: clear mandates, operational autonomy and an accountability in law. An institutional framework that has enabled the evolution of the modern monetary policy toolkit.¹⁵

Independent monetary policy allows interest rates to be set according to economic cycles rather than political cycles. Monetary policy operates with lags. A longer horizon is therefore essential if policy is to stabilise inflation rather than chase short term outcomes.

A substantial empirical literature supports these observations. Early work by Cukierman, Webb, and Neyapti¹⁶, and by Alesina and Summers¹⁷, showed that higher levels of central bank independence are associated with lower inflation without adverse effects on growth. More recent research confirms that these relationships remain robust in the post global financial crisis environment.¹⁸

Work by Davide Romelli of Trinity College Dublin and his co-authors shows that reforms enhancing independence improve monetary credibility, particularly in economies facing fiscal pressures.¹⁹ Adam Posen has emphasised that formal independence must be supported by political and financial system structures if it is to be effective.²⁰

The evidence is strongest for monetary policy. The case for independence in other areas of a central bank’s mandate, such as macroprudential policy and financial regulation, is compelling, there is clear evidence that political economy cycles impact regulation and supervision, but also complex (as, unlike inflation, the target is not observable, although that does not make it any less important).

In Ireland, our mortgage measures provide a practical example: independently set, transparently explained, and regularly reviewed, they have helped improve resilience and protect consumers, while remaining accountable to the Oireachtas and the public. Financial regulation of banks, or microprudential supervision, takes place either at a national or at a European level, with shared responsibility and oversight with ECB Banking Supervision.

Accountability

This brings me to mandates and accountability.

Independence is credible when a mandate is clear. In democratic systems, societies, through their parliaments, delegate specific powers to central banks. Central banks are accountable to parliaments. We publish our analysis and we explain our decisions. Our mandates are defined in law and our appointments as governors are time-bound.

Accountability enhances trust which in turn safeguards independence.

Paul Tucker, former Deputy Governor at the Bank of England, argued persuasively that the sustainability of delegation depends on careful institutional design. Independence without accountability is fragile. Accountability without independence is ineffective.²¹ An anchor is more than a hook. It is the weight of the chain that holds the ship in place. In institutional terms, that chain is the legal accountability framework.

Which brings me to trust. Trust is at the heart of our society: trust in the rule of law, trust in the structures of our government and trust in the state's institutions. Without trust the ability of central banks to tackle inflation, preserve financial stability, and even issue money is undermined. Christine Lagarde has emphasised that trust is the foundation of central banking and that trust is earned through transparency, dialogue, and international cooperation.²² Agustín Carstens has argued that independence must be actively safeguarded in the face of heightened political expectations.²³

Central bank independence is best understood as an institutional bedrock. It stabilises policy making. It allows difficult decisions to be taken in the long-term interests of the economy and the country. But like all institutions, it depends on trust.

That trust is reinforced through engagement, transparency, and accountability. Independence does not mean isolation. In an interconnected world, credible and effective central bank policies – and not only in the area of monetary policy – require dialogue with society more broadly and with other institutions responsible for economic governance such as government departments, fiscal authorities and watchdogs, regulators, and international institutions.

It also means being well-connected with those institutions in our society that shape economic ideas. There are different examples of the type of institutions I have in mind, but universities, where we are today, are a prime example. This is one of the reasons why at the Central Bank of Ireland we have prioritised a fundamental rethink of our research engagement strategy. Being more open in how we engage with the academic community – through, for example our Research Affiliate and Visiting Scholar programmes, has not only raised our game in terms of the quality of our research and skill-set but has also challenged our own thinking around policy, guarding against group-think.²⁴

Challenges

Being well-connected to the external environment also helps to understand and prepare for the challenges ahead. There are two in particular that I want to flag today.

The first is the risk of fiscal dominance. In January the IMF expressed concern at the level of public debt in several major economies, pointing out that fiscal sustainability worries could not only put pressure on borrowing costs but also tighten broader financial conditions and amplify financial market volatility.²⁵ The responsibility is on governments to make sure they do not put central banks in a position where they are forced to choose between sovereign solvency and price stability.

The second challenge is the responsibility of central banks. The ongoing communications revolution means that tastes and preferences for the consumption of news and information are also undergoing change. If they are going to continue to be trusted and if they are going to continue being credible, central banks will have to make sure they also keep up to speed with the changes taking

place in the communities they serve. This puts greater weight on engagement, and on being prepared to do things differently and, indeed, do different things.

Conclusion

Any sailor will tell you that anchors matter in all waters. Their design matters.

In a democracy, the design of institutions, their roles and functions, their measures of success and their accountability mechanisms – are ultimately a matter for societies and their parliaments. The design is a political decision reflecting preferences and intentions.²⁶

The case for price stability is strong: to protect real incomes, reduce uncertainty for households and firms, and support sustainable employment. As the founding legislation of the Central Bank of Ireland makes clear, it is about the “welfare of the people as a whole”.

Equally strong is the case for price stability to be delivered by an independent central bank.

Maintaining that independence and its legitimacy requires sound institutional design, rigorous analysis, and open engagement with the societies we serve.

It also requires humility, self-reflection, and an openness to learn and change. While central banks' goals are often given by statute or laws, the strategy to achieve those goals is not. This is why central banks should hold regular reviews of their policies and frameworks to ensure that they remain fit for the future, even if those policies and frameworks have proved successful in the past.

As I've said before, if we simply focus on preserving institutions, we may in fact find that we are weakening them.²⁷

Independence is a means to a public end; it requires continuous maintenance, analysis, engagement and review. As a central banker let me finish by acknowledging that our legitimacy rests on delivering outcomes for the people we serve and being accountable for the decisions we make.

[1] Thank you to Seán O'Sullivan, Vasileios Madouros, Reamonn Lydon and Giuseppe Corbisiero for their help with these remarks.

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