

SPEECH

# Central bank independence in an era of volatility

## Lamfalussy Lecture by Christine Lagarde, President of the ECB, at the Lamfalussy Lectures Conference organised by the Magyar Nemzeti Bank, pre-recorded in Frankfurt am Main on 15 January 2025

*Budapest, 27 January 2025*

In his later years, Alexandre Lamfalussy was once asked what his fundamental motivation in life was. He recalled the experience of his turbulent youth, surrounded by the destruction caused by the Second World War.<sup>[1]</sup> “In the aftermath of the war,” Lamfalussy said, “I decided to serve the community in the rebuilding of Europe.”<sup>[2]</sup>

He went on to do just that. A member of the Delors Committee and the first President of the European Monetary Institute, Lamfalussy helped pave the way for Europe’s monetary union and the establishment of the ECB.

His generation had also been scarred by the difficulties of the “Great Inflation” in the 1970s.<sup>[3]</sup> And so Lamfalussy – alongside other architects of the euro<sup>[4]</sup> – ensured that the ECB would have sufficient powers to prevent a scenario where inflationary expectations once again became embedded in the economy.

We can see proof of this today, as advanced economies emerge from the largest inflation shock in a generation.

As in the 1970s, a series of shocks contributed to high and persistent inflation. But unlike the 1970s, inflation has since fallen relatively fast across advanced economies – and expectations have remained firmly anchored throughout.

This hard-won progress has been in large part due to the independence of central banks, which has given them the ability to take difficult but necessary monetary policy decisions in pursuit of stable prices.

### The rise of central bank independence

In the late twentieth century, central bank independence spread rapidly around the world.

A strong social consensus about its benefits – emerging from the negative experience of the 1970s – sparked what Lamfalussy would later call a “sea change” in monetary policymaking.<sup>[5]</sup>

By one account, over 80% of the world’s central banks became operationally independent by the turn of the millennium.<sup>[6]</sup> And price stability had been adopted as the primary objective of monetary policy

frameworks across almost all advanced economies and many emerging market economies.<sup>[7]</sup>

Moreover, independent central banks both contributed to – and benefited from – a period of low macroeconomic volatility.

In their famous paper, Alesina and Summers found a positive relationship between the degree of independence of central banks and lower and less volatile inflation outcomes.<sup>[8]</sup> At the same time, substantial structural changes were afoot in the global economy, which also helped to reduce macroeconomic volatility – an era that soon came to be known as the Great Moderation.<sup>[9]</sup>

Globalisation led to an enormous increase in both global labour supply and production capacity, which meant that prices and wages were often little affected even in the face of strong demand. And the oil crises of the 1970s had sparked a wave of change in global energy markets, resulting in a more elastic energy supply.

The upshot of the Great Moderation was a virtuous circle.

An environment of low macroeconomic volatility made it easier for independent central banks to deliver on their price stability mandates. That, in turn, solidified the social consensus in support of central bank independence and helped ensure its growing adoption around the world – further contributing to lowering levels of volatility.

## The era of volatility

The end of the Great Moderation came suddenly and unexpectedly in 2008 with the arrival of the global financial crisis. And over the last years in particular, our world has changed dramatically.

Indeed, the two forces that fostered the spread of central bank independence – a strong social consensus and growing pools of global supply – are now coming under increasing pressure.

While recent research suggests that *de jure* central bank independence has never been more prevalent than it is today<sup>[10]</sup>, there is no doubt that the *de facto* independence of central banks is being called into question in several parts of the world.

One study examining 118 central banks in the 2010s shows that around 10% of them faced political pressure in an average year – even those central banks with a high degree of *de jure* independence.

<sup>[11]</sup> Another paper finds that between 2018 and 2020 alone, *de facto* central bank independence deteriorated for almost half of those central banks in jurisdictions accounting for 75% of global GDP.<sup>[12]</sup>

There is evidence to suggest that political influence on central bank decisions can also contribute substantially to macroeconomic volatility. For instance, persistent political pressure on a central bank has been found to affect the level and the volatility of exchange rates, bond yields and the risk premium.<sup>[13]</sup>

At the same time, geopolitical tensions threaten to amplify volatility by increasing the frequency of shocks hitting the global economy.

We have already seen the impact of geopolitical tensions play out in Europe. Following Russia's invasion of Ukraine in early 2022, average output growth volatility in the euro area surged by 60%

compared with before the global financial crisis, while average inflation volatility shot up by 280%.<sup>[14]</sup> An environment of heightened volatility could make the task of maintaining price stability more difficult to achieve.<sup>[15]</sup> This could raise concerns that independent central banks are failing to deliver on their mandates, which could undermine the social consensus and further amplify volatility in the economy. So, the question that comes to the fore is: will the current era of volatility turn the virtuous circle that facilitated the rise of central bank independence into a vicious circle that leads to it being undermined?

## **The benefits of central bank independence in today's world**

All things considered, I would argue that this is unlikely to happen.

A volatile macroeconomic environment actually makes the benefits of central bank independence all the greater. We saw this during the recent inflation shock.

In OECD countries, average annual inflation surged to 9.6% in 2022 as they faced a variety of shocks that compounded each other.<sup>[16]</sup> In response, independent central banks sharply increased policy rates.

These actions led to a rapid decline and convergence in the respective inflation paths of major economies – despite all these economies facing different shocks. Moreover, inflation expectations have remained firmly anchored, suggesting that the public continues to have faith in independent central banks' commitment to price stability over the long run.<sup>[17]</sup>

In today's world, central bank independence offers two key advantages.

First, it acts as a headwind to volatility in these unpredictable times.

As we emerge from a period of very high inflation, the issue of time inconsistency is more relevant than ever.<sup>[18]</sup> Compared with the pre-pandemic era of low inflation, central banks may need to contend with lower levels of rational inattention.<sup>[19]</sup>

In this environment, credible policy regimes become even more important for maintaining trust in central banks. Research finds that higher trust in the ECB lowers inflation expectations on average and significantly reduces uncertainty about future inflation.<sup>[20]</sup>

Second, central bank independence also contributes to regional strength in a world increasingly defined by geopolitical rivalries.

Price stability provides the foundation upon which other strategic goals can be achieved. Regions with stable prices tend to have more efficient resource allocation and higher levels of competitiveness, and they attract greater levels of investment. At heart, strong economic institutions are the fundamental cause of long-run economic growth and development differences between regions.<sup>[21]</sup>

## **Conclusion**

Lamfalussy once described the task of launching the euro as “navigating in uncharted waters”.<sup>[22]</sup> In an era of volatility, independent central banks now also find themselves in unfamiliar waters.

While inflation has fallen sharply, central banks are still likely to face a more volatile macroeconomic environment compared with the Great Moderation.

It therefore remains imperative that central banks have the independence to fully deliver on their price stability mandates.

Thank you.

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1.

These remarks were pre-recorded in Frankfurt am Main on 15 January 2025.

2.

Lamfalussy, C., Maes, I. and Péters, S. (2013), *Alexandre Lamfalussy: The wise man of the euro. A conversation with Christophe Lamfalussy, Ivo Maes and Sabine Péters*, LannooCampus, p. 185.

3.

Bordo, M.D. and Orphanides, A. (eds.) (2013), *The Great Inflation: The Rebirth of Modern Central Banking*, University of Chicago Press.

4.

Maes, I. (2016), "Alexandre Lamfalussy: A Cassandra about Financial Stability", in Dyson, K. and Maes, I. (eds.), *Architects of the Euro*, Oxford University Press, pp. 241-249.

5.

Lamfalussy, A. (1997), "The European Central Bank: Independent and Accountable", in Maes, I. (ed.) (2017), [\*Alexandre Lamfalussy: Selected Essays\*](#), Magyar Nemzeti Bank, p. 331.

6.

Haldane, A. (2020), "[What Has Central Bank Independence Ever Done for Us?](#)", speech at UCL Economists' Society Economics Conference, 28 November, citing Garriga, A. (2016), "Central Bank Independence in the World: A New Dataset", *International Interactions*, Vol. 42, No 5, pp. 849-868.

7.

Dall'Orto Mas, R. et al. (2020), "[The case for central bank independence – a review of the key issues in the international debate](#)", *Occasional Paper Series*, No 248, ECB, October.

8.

Alesina, A. and Summers, L.H. (1993), "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence", *Journal of Money, Credit and Banking*, Vol. 25, No 2, May.

9.

Bernanke, B. (2004), "[The Great Moderation](#)", remarks at the meetings of the Eastern Economic Association, Washington, DC, 20 February.

10.

Romelli, D. (2024), "[Recent trends in central bank independence](#)", *VoxEU CEPR*, 26 February.

11.

Specifically, between the years 2010 and 2018. See Binder, C. (2021), "Political Pressure on Central Banks", *Journal of Money, Credit and Banking*, Vol. 53, No 4, June, pp. 715-744.

12.

Dall'Orto Mas, R. et al. (2020), "[The case for central bank independence – a review of the key issues in the international debate](#)", *Occasional Paper Series*, No 248, ECB, October.

13.

Çakmakli, C. et al. (2024), "Do Financial Markets Respond to Populist Rhetoric?", *Oxford Bulletin of Economics and Statistics*, Vol. 86, No 3, June, pp. 541-567. See also Demiralp, S. (2024), "[Silence is golden: How public criticism of central banks can backfire for leaders](#)", *VoxEU CEPR*, 18 April.

14.

Average output growth volatility relates to year-on-year euro area real GDP growth. The figure for average inflation volatility is derived from year-on-year HICP inflation for the euro area. The two reference periods are the 28 months following Russia's invasion of Ukraine and the 28 months leading up to the collapse of Lehman Brothers in 2008.

15.

In parallel, see also Afrouzi, H. et al. (2024), "[Changing Central Bank Pressures and Inflation](#)", *Brookings Papers on Economic Activity*, BPEA Conference Draft, 28-29 March, who argue that several economic and political economy factors may lead to a structurally higher inflation environment.

16.

Including Türkiye. See OECD, "[Inflation \(CPI\)](#)".

17.

This speaks to Lamfalussy's own prescient observation in the lead-up to the creation of the ECB. He argued that the new central bank "will have no track record of its own ... This implies that financial markets and the general public will assess the performance of the ECB on the basis of the effectiveness of the monetary policy framework adopted and the ability to act in accordance with its primary objective." See Lamfalussy, A. (1997), "The European Central Bank: Independent and Accountable", in Maes, I. (ed.) (2017), [Alexandre Lamfalussy: Selected Essays](#), Magyar Nemzeti Bank, p. 334.

18.

Kydland, F. and Prescott, E. (1977), "[Rules Rather than Discretion: The Inconsistency of Optimal Plans](#)", *Journal of Political Economy*, Vol. 85, No 3, pp. 473-491; Barro, R. and Gordon, D. (1983),

[“Rules, Discretion and Reputation in a Model of Monetary Policy”](#), *NBER Working Papers*, No 1079, National Bureau of Economic Research, February.

19.

Survey evidence for the euro area suggests that in early 2023, over 60% of citizens were paying more attention to inflation relative to a year earlier. See D’Acunto, F. et al. (2024), [“Household Inflation Expectations: An Overview Of Recent Insights For Monetary Policy”](#), *NBER Working Papers*, No 32488, National Bureau of Economic Research, May.

20.

Christelis, D. et al. (2020), [“Trust in the Central Bank and Inflation Expectations”](#), *International Journal of Central Banking*, Vol. 16, No 6, December.

21.

Acemoglu, D. et al. (2005), “Chapter 6: Institutions as a Fundamental Cause of Long-Run Growth”, *Handbook of Economic Growth*, Vol. 1, Part A, pp. 385-472.

22.

Lamfalussy, C., Maes, I. and Péters, S. (2013), *Alexandre Lamfalussy: The wise man of the euro. A conversation with Christophe Lamfalussy, Ivo Maes and Sabine Péters*, LannooCampus, p. 11.

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