Central bank independence is facing its biggest stress test of this century

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Central bank independence is not as hard-wired in modern institutions as they might appear to anyone born after the 1970s. That it went largely unchallenged in its first thirty years of history owes much to economic circumstances. But in today's world of supply shock-driven inflation and large public debts, central banks face a much harder task. A series of controversial decisions since the global financial crisis, and years of above-target inflation leaves them more vulnerable than ever to political attacks on their independence. It is imperative to defend it, as there will be large costs to pay if it is lost.

For anyone born after the 1970s, central bank independence has felt like part of the permanent architecture of modern governance. Like the separation of the branches of government or the between church and state, the idea that setting interest rates should be taken out of the hands of politicians became an unquestioned consensus across advanced democracies and, increasingly, beyond them.

Yet central bank independence is remarkably recent. For most of the twentieth century, treasuries and finance ministries dictated or heavily influenced monetary policy decisions to try and juice up growth ahead of elections or otherwise avoid painful decisions. Time and again, the lesson had to be re-learned: when politicians control the printing press, the result is chronic inflation and volatile growth.[1] Over the past three decades, granting central banks operational autonomy became the global standard. To elected policymakers the setting of goals: always, price stability, sometimes a growth or full employment mandate alongside; to technocrats with long fixed terms in office the freedom to raise or lower borrowing costs as they saw fit, regardless of the political calendar.

For thirty years, this model enjoyed limited pushback. Not that central banking was easy. True, the so-called "Great Moderation" period (from the mid-1980s to the Global Financial Crisis of 2007-8) owed both to good luck (globalization keeping prices down and IT driving productivity up) and as to good policies. But there were still a multitude of crises to deal with –sovereign defaults, balance of payments crises, financial institutions going belly up, even before the GFC, and then a long period of below target inflation, followed by the most unexpected shock of all times: a global pandemic that shut down the global economy. Some central banks did better than others in meeting their assigned goals during these decades, and many central bank decisions were heavily criticized, but by and large, inflation wasn't a top-of-mind issue for the public, and (consequently?) central bank independence itself was just not questioned.

But that era is over. Today, central bank independence is facing the most dangerous stress test of its history, caught between the anvil of challenging economic circumstances and the hammer of political opportunism.

Central bank independence exists primarily to guard against two temptations from elected governments: inflating away runaway public debt (by printing money to buy the said debt) and choosing growth whenever there is a short-term tradeoff between it and price stability. For decades, advanced economies rarely had to confront either in extreme forms. Today, both have returned.

First is the sheer scale of sovereign debt. Across the G7, government debt-to-GDP ratios have surged to heights unseen outside of wartime and are generally on track to keep growing based on current policies (see Chart 1).

When interest rates were very low, or well below the economy's growth rate, carrying this debt was relatively painless. But sovereign borrowing costs have skyrocketed in recent years (see Chart 2), owing to a combination of central bank policies and, more recently, greater competition for capital all across the global economy as both public and private sector face new investment needs (in defence, AI, supply chains risk-proofing) in addition to old ones (energy transition, ageing societies). As growth rates have not, the fiscal effort needed to obtain a declining debt/GDP ratio is growing (see Chart 3).

This is the essence of "fiscal dominance", a scenario where the central bank is under pressure to lower interest rates or use its balance sheet to help fund government spending. Note that the more a government funds its debt at the short end of the yield curve, the more it is sensitive to central bank rate setting. As it happens, the average maturity of government debt has been falling across most G7 countries, especially in the US. And recent announcements by the US Treasury Secretary indicate plans to accelerate this trend through much higher buybacks of longer-dated debt to be financed by short-term debt issuance.

Second is the nature of today's inflation. From the 1980s to the COVID pandemic, inflation was driven by demand shocks, with excessive demand causing too high inflation and insufficient demand causing too low inflation. But more recently, price spikes have been driven by supply bottlenecks — whether stemming from geopolitical conflict, climate events, or health emergencies. We can expect this pattern of repeated and overlapping supply shocks to persist as long as today's perturbed geopolitical and natural environment.

When central banks act to protect price stability under these conditions, it is much harder for them to deliver a painless landing. Raising interest rates does not replace the missing goods; the best it can do is to prevent a wage-price spiral from taking hold. And while a credible central bank may not need to act much, they may still have to make decisions that directly hurt all borrowers — whether it be households, governments or businesses, making them easy targets for blame.

If that wasn't challenging enough, the relative political consensus that once shielded central bankers from interference is showing cracks. This is the result of several waves of controversial decisions by central banks, first to help stabilise the financial system in the wake of the global financial crisis, then to fight inflation from below target with large balance sheet expansions to purchase financial assets during the second half of the 2010s[2], and finally several years of inflation well-above 2%.

In the United States, President Trump has been relentlessly attacking the Federal Reserve and its leadership out of anger that they have not cut interest rates more. Financial markets have been unsure whether the Chairman he appointed will deliver the policy tightening that appears likely to be needed to restore price stability. In Japan, political leaders have publicly urged the Bank of Japan to keep yields low to support the government's spending plans, complicating the bank's efforts to normalize policy. In both cases, markets have reacted by pushing the currency down and term premium up, acting as a guardrail for now. In response, Fed Chair Warsh's delivered a speech at the Jackson Hole Symposium last week that assuaged doubts about his commitment to price stability, for now.

But the erosion of institutional restraints is not confined to these countries. In the UK and Canada, prominent opposition party leaders have been virulent in their criticism of central bankers, framing them as unaccountable technocrats serving global financial elites at the expense of ordinary working citizens.

Meanwhile in France, one of the leading candidates in the upcoming presidential election is advocating monetizing French public debt by having the eurosystem “cancel” the roughly 18% of it that it currently holds. This cannot happen as it would violate several fundamendal legal underpinnings of the European Monetary Union[3]. But any Eurozone government pushing for this would fundamentally undermine trust in its sovereign debt and in the euro, leading to a loss of value for both alongside borrowing costs—the same market reaction observed recently with US and Japanese government bonds and currencies, but on a much larger scale.

When a central bank is seen as not entirely free to do what is needed to deliver price stability, inflation expectations can become unanchored. Financial markets demand higher risk premiums, bond yields climb, and everyday borrowing costs from thirty-year mortgages to consumer credit and corporate loans rise, slowing down growth. With sovereign debt now traded predominantly by impatient investors like hedge funds rather than more patient ones like central bank reserve managers or pension funds, market reactions are brutal and could be unforgiving.[4] Once lost, credibility takes not only time but action to restore, demanding a higher economic cost to restore price stability than would be the case under a fully credible central bank.

Independent central banks are not unaccountable, indeed the opposite. More than ever, they must actively explain their choices in plain, accessible language, demonstrating to the public why resisting instant pain relief today prevents systemic economic decay tomorrow.

Simultaneously, business leaders, institutional investors, independent researchers and thoughtful policymakers, while free to comment and criticise, must stand as a vocal buffer against political encroachment. Central bank independence was never a natural law; it is an institutional compromise born out of painful experience. If we allow it to fail this stress test, there will be a heavy economic price to pay just around the corner.

Surrendering central bank autonomy will not solve structural budget deficits, lower grocery bills, or resolve geopolitical turmoil. It will simply remove a tried and tested institutional speed limit on short-sighted and ill-advised macroeconomic management.

[1] See for example Central Bank Independence and Macroeconomic Performance: Some comparative evidence, Alberto Alesina and Lawrence Summers, 1993.

[2] This was dubbed “quantitative easing” and was adopted by most advanced economies’ central banks to provide additional monetary easing after they had reached the point where they could not lower the policy rate further, While a large proportion of the financial assets purchased consisted of government bonds, these were exclusively driven by the needs of monetary policy as independently determined by these central banks.

[3] The principles of no debt monetization, no bail-out and central bank independence, set in Articles 123, 125 and 130 of the Treaty on the Functioning of the EU.

[4] See Bank of International Settlements, Annual Economic Report 2026, Chapter II. High public debt and shifting financial markets: challenges for central banks

Equity indices, currencies, commodities, bond markets. [...]

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