

CURRENT THREATS TO CENTRAL BANK INDEPENDENCE¹

Introduction

Central bank independence is a social and political convention, often enshrined in law, that addresses a basic tension between the short-term interest of those who rule and the long-term interest of those who are governed.

Current convention has its origins in:

- Demonstrated capacity of central banks to tame rampant inflation, though at some economic cost (Volcker in the 1980s);
- Demonstrated ability of central banks to maintain price stability, if not subject to fiscal dominance (the 'great moderation');
- Recognition that a commitment to low and stable inflation requires monetary policy undertaken by central banks to take a longer-term view than the electoral cycle in a democracy (Kydland and Prescott 1977, Alesina and Summers, 1993).

Independence of a public authority can never be absolute as it is the government which grants, sustains and can remove that independence. But it can be given a solid legal foundation, which is usually the case when a central bank is given independence to set monetary policy (the international treaty which created the ECB for example, or the Bank of England Act, 1998).

Why is the independence of central banks presently under threat?

There are at least three inter-twined sources of risk to CB independence: the growth of populism in developed countries; the associated risks of fiscal dominance; and changes in technology that are likely to re-shape the financial landscape.

POPULISM

Populism can be defined as a political stance appealing to the instincts of the 'ordinary people' rather than serving the interests of so-called 'corrupt elites'. There is often an explicit element of nationalism and demonisation of opponents, both within and without. Catering to the instincts of the people is a practice with an ancient lineage. Juvenal, born at the time of Nero, noted how even emperors would use 'panem et circenses' to seek popularity.

The rise in populism in developed countries since the start of the millennium is widespread. It is now, as our headlines amply demonstrate, most in evidence in the US. Populist parties have also gained significant ground in Germany, France, Italy, Japan and the UK amongst others.

¹ Synopsis of themes considered at roundtable discussions on 9 December 2025. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Members have included Vitor Constancio, Sir Jon Cunliffe, Stefan Ingves, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, His Highness Mohammed Sanusi II, Andrew Sheng, Masaaki Shirakawa, Sir David Walker Axel Weber and Dr Zeti Aziz. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

Although populism also rears its head in developing countries - it has long been in evidence in Russia and Turkey - higher natural growth rates have perhaps made the threats to central bank independence more muted, even where populism has some hold, such as India and Malaysia.

EXCESSIVE DEBT

Populist governments are reluctant to tax and keen to spend. This causes government debt to swell. With productivity trends slowing and GDP growth weakening, and after episodic fiscal expansions caused by events such as the Great Financial Crisis of 2007-09 and the Covid-19 pandemic of 2020-21, the prospect of sovereign debt levels becoming unsustainable looms large. This raises the spectre of default or repudiation in some form.

Excessive debt can lead to threats to independence for the following reasons:

Firstly, governments may be tempted to use inflation as a more subtle and pernicious way to restore debt sustainability than direct repudiation with its huge costs. However misguided such a policy might be, to achieve it they would need to suborn central banks hence attacking their independence. The combination of fiscal profligacy and a desire to lower interest rates makes the US a candidate for such pressure. In that context Quantitative Easing (QE) has complicated the landscape. Now that central banks have massively expanded balance sheets arising from QE when inflation and interest rates were very low, populist politicians ask why they cannot just create money to finance the populist agenda, regardless of the increase in inflationary pressures.

Secondly, central banks could be made scapegoats by government for poor economic performance arising from burdensome debt servicing costs. Pressure would then likely arise for governments to take back control over for example monetary policy directly.

TECHNOLOGY

Digital technology provides ample sources of tension between central banks and governments, and hence threats to central bank independence. This is a particular challenge now in the US where powerful financial and political supporters of the administration are resisting efforts by the central bank to itself become involved in developing a digital currency.

Alternative stores of value purporting to be money (crypto currencies), changes in payments and settlement technology arising from the associated distributed ledger technology, and the effects of machine learning and agentic AI, all pose profound challenges for central banks. Fractional reserve banking underpins both traditional finance and the mechanisms for implementing monetary policy. Disintermediation of the banking system by new, non-bank service providers, contains hazards for central banks in delivering their mandates where their ability to mitigate risks is being eroded by huge growth in private non-bank credit, for example via private equity involvement in life insurance and pension guarantees. This is relevant for both monetary policy but also financial stability.

The challenges of regulating new technology are complicated. On the one hand, normal central bank risk aversion could stifle progress to a more efficient financial system. Meanwhile, the owners and promoters of AI and alternative finance are amongst those who wish to be unconstrained by all forms of regulation: social, political or legal, and thus tend to support the populist right. This includes through the financing of political campaigns supporting those that

seek political power. Meanwhile the social media which they control is becoming the dominant political battleground, making the relationships even more entwined.

Central banks and other regulators have been working hard to understand the consequences of new technology for financial and monetary stability, but it remains to be seen whether they will be allowed any authority to regulate alternative finance. Meanwhile, the current hiatus in regulation is possibly the worst outcome both for financial stability and for those developments which could change the financial sector for the better.

What can central banks do better to reduce the threats?

Here are five areas where central banks can play a role:

STICKING TO THEIR CORE MANDATES AND ACHIEVING THEIR TARGETS

To maintain trust, central banks need to stick to their core roles of monetary policy and financial stability and to deliver on those mandates. Whatever the colour of government, the benefits of these two policy areas to the general public are unlikely to change over time. So, where they can do so, they should resist accepting secondary roles or tasks unrelated to those core mandates, or, as in the case of climate change or crypto currencies, be extremely careful how they seek to articulate and mitigate the significant risks to their objectives arising from such politically contentious sources.

Taking each of their two core mandates in turn, this implies that central banks should:

Monetary Policy.

- Better articulate their mandates, as achieved by the Fed in August 2025, when it made it clear that its objective was the highest level of employment consistent with price stability. Concern about rising living costs, 'affordability', may help to reinforce the downsides of high inflation – which are suffered by nearly everybody, but especially lower- and middle-income earners.
- Be more aggressive pursuit of lower inflation. The rise in inflation post-Covid has clearly damaged central bank credibility and inflationary pressures remain stubbornly high in some countries. Calling for governments to respect independence when it is not delivering the required outcome, is a difficult sell.
- Take added care with the use of balance sheets to avoid any risk or even perceptions of monetary financing.
- Consider investing more resources into research on the reasons for slowing real growth. Central banks suffer collateral damage when the economy is not performing well, even if the cause lies elsewhere. There is still no commonly accepted explanation for slowing productivity growth trends in developed countries, which enables some to argue that tight monetary policy is the cause.

Financial stability

- Demonstrate positive, public steps towards making microprudential and macroprudential policies fit for purpose, with greater emphasis on mitigating the consequential constraints on growth.
- Continue their vital contribution to recovery and resolution planning. Central banks will also need to demonstrate that they can be relied upon to intervene effectively and quickly in a financial crisis, including acting as both as a lender and a market maker of last resort.

IMPROVE THEIR COMMUNICATION CAPABILITIES AND SKILLS

Sticking to the core mandate and even success in keeping inflation around 2 percent is unlikely to be sufficient to protect central bank independence against populist pressures. Improvement is also required across the board in communications to all major stakeholders and in respect of all their mandated objectives. Central banks have generally developed expertise in communicating on a technical level with financial markets, the financial press and economists. Their attempts to communicate directly more broadly with ordinary people have however been less successful. To retain the necessary public support for independence, however central banks need to demonstrate to the person in the street the vital role they are playing as well of the importance to the public, in containing inflation, ensuring affordability, and preventing instability. This will require conscious effort in what for many of them is a relatively unfamiliar field.

MANAGE TENSIONS WITH GOVERNMENT

There is only so much that central banks can do when faced by a government determined to get its own way. To secure their mandated objectives, central banks must handle political relations in the light of the stance of the government of the day. Regular but balanced communication with the government, particularly at the most senior levels, can build understanding and confidence. They should therefore do their best to explain consequences and demonstrate their resolve to perform their mandates. Arguably, faster and more aggressive action in the face of rising inflation would have enabled easing to come earlier, thus lessening tensions overall.

Direct responsibility for sovereign debt levels lies with government, but the risk of an unsustainable path is always going to be of manifest concern to CBs. The normal convention is that central banks do not criticise fiscal policy and governments do not comment on monetary policy. It is easier for governments to break that convention than central banks. However, the electorate surely understands that too much debt is dangerous. And consequently, if skilfully presented at the right times, such commentary could be both nonconfrontational and effective.

ADDRESS THE CHALLENGE OF TECHNOLOGY

Central banks need to demonstrate their awareness and understanding of digital technology and identify the risks and benefits of alternative finance in a balanced way. They also need to advance the case for potential regulatory solutions which would be acceptable, even if they are not granted direct powers to intervene themselves. Such solutions could require a different approach from the traditional banking regulatory model – a standards or output-based approach being one possibility given that in new and fast-moving areas of change it can be easier to define the outputs needed than trying to write rules to achieve them.

SAFEGUARD INTERNATIONAL CENTRAL BANK COOPERATION

The stability of the world's financial system has depended for nearly a century on quiet, effective cooperation amongst central banks, such as within the Basel framework. That cooperation is more essential than ever in a fractured, multipolar world. But it is also far more difficult when governments distance themselves from a world order based on international

understandings, norms and standards. In a way, this places added responsibility on central banks who need to

- Help forge agreement on the regulation of all types of financial intermediation, not just that of fractional reserve banks.
- Ensure that currency swap lines will work seamlessly in the event of a crisis. This may involve the Fed articulating (well in advance of their use) why providing these swap lines is in the interests of the US, not just the counterparty country.
- Address the common risks and benefits of new technologies and new players in the financial sector.

Conclusions

Central banks cannot themselves stand in the way of the populist enthusiasm of voters, halt the rise in sovereign debt or avoid the consequences of tectonic shifts in technology. They can however do their best to demonstrate their value as neutral, effective and professional institutions serving the greater social good. Quiet determination to identify and communicate risks, pursue policies within their mandates and take proactive measures such as those above should itself over time help to reinforce the value, and create more general support, for the case for central banks remaining independent.

References:

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Kydland, F. and E. Prescott (1977), "Rules rather than discretion: The inconsistency of optimal plans", *Journal of Political Economy*, 85, 473-490