



The merits of central bank independence

Central bank independence was created to address a fundamental problem – the temptation for governments to trade long-term stability for short-term popularity.

Chris Jones considers the topic of political interference in the running of institutions like the US Federal Reserve Board

In August 2025, Donald Trump shocked financial markets by attempting to remove Lisa Cook, a governor on the Federal Reserve Board (the 'Fed', which, like the UK's Bank of England, is a central bank and is responsible for setting interest rates in the USA) over alleged irregularities in her mortgage paperwork. Most political and economic commentators quickly recognised that the case was not really about mortgages. Instead, it has been seen

as a warning – if the Fed resists Trump’s calls for lower interest rates, its officials could face political retaliation.

The move was alarming because the Fed is one of the institutional foundations of America’s economic stability. If politicians could bend central banks to their will, decisions about interest rates might start to be based on short-term electoral advantages rather than long-term stability. In the extreme, it may even lead to the monetisation of a country’s debt (when the central bank buys government debt).

The political interference matters because monetary policy works largely through the expectations of economic agents such as households and firms. If economic agents believe the Fed will keep inflation under control, they set wages, prices and contracts on the assumption that inflation will remain low, or at least close to the set inflation target. Economists call this ‘anchoring expectations’. But if they fear that the Fed will bow to political pressure, those expectations can become ‘unanchored’, making inflation harder to fight, leading to more volatile inflationary pressure.

What monetary policy does

At its core, monetary policy is about controlling the supply of money and the cost of borrowing (the rate of interest or federal funds rate). When inflation is rising too fast, the Fed raises interest rates to cool aggregate demand (contractionary monetary policy) in the economy and slow down price increases. When the economy is weak, it cuts rates to stimulate aggregate demand (expansionary monetary policy). Both can be seen in Figure 1.

This balancing act only works well if people trust central banks, like the Fed, to put the long-term health of the economy above political convenience. Politicians, however, face short-term election cycles. They may prefer lower interest rates before an election to make growth feel stronger, even if this risks higher inflation later. This is known in economics as the ‘time inconsistency problem’ –

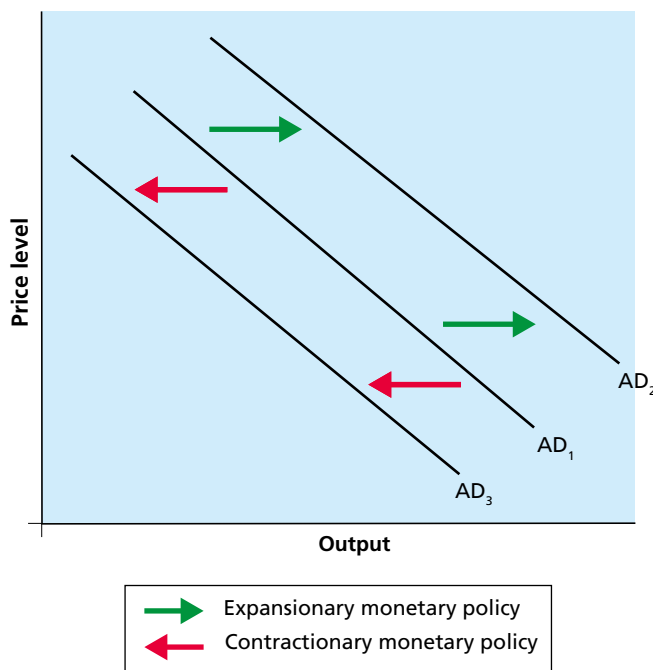


Figure 1 How does monetary policy work?

the temptation to make short-term choices that undermine long-term goals. In Trump’s case, he faces important mid-term congressional elections that might constrain his ability to set economic policy.

The importance of central bank independence became clear in the 1970s and 1980s. Inflation expectations had drifted upward as people lost faith in governments’ willingness to resist inflationary pressure. Economists Finn Kydland and Edward Prescott explained this dynamic in an influential model. They showed how politically controlled monetary policy could fall into a ‘credibility trap’ – promising low inflation but delivering high inflation. Their solution was to give decision-making power to an institution insulated from politics – the independent central bank.

By the 1990s, their ideas had spread widely. The UK government granted independence to the Bank of England in 1997 and the European Central Bank was set up with independence written into its DNA. The rationale was simple – credibility matters, and credibility requires independence from political interference.



Why independence still matters today

The Trump–Fed dispute shows why these debates are not just history. Even if financial markets have not panicked yet, each attempt to politicise the Fed weakens a vital norm of American democracy – that central banks should be free from political interference. If that norm erodes, two risks follow.

First, inflation expectations could become unanchored. If households and firms begin to believe that the Fed will give in to political pressure and tolerate higher inflation, they will act in ways that make inflation harder to control.

Second, financial markets will start demanding higher interest rates to lend to the government, since they will worry about the risk of poor policy decisions. Ironically, the attempt to force lower rates could result in higher long-term borrowing costs for the state and its citizens, and put significant pressure on the government’s ability to deliver social programmes.

It is important to note that independence does not mean unaccountability. The Fed must still explain its decisions publicly, justify its targets, and be overseen by Congress. The same can be said about the UK’s Bank of England and its monetary policy framework, where an inflation report is published regularly, and the Monetary Policy Committee members face scrutiny from several

sources. But independence ensures that when hard choices must be made, those decisions are based on long-term economic health rather than the short-term interests of politicians.

Conclusion

Central bank independence was created to address a fundamental problem – the temptation for governments to trade long-term stability for short-term popularity. Decades of experience demonstrate that independence helps keep inflation low and expectations anchored. That is why recent political pressure on the Fed is so concerning. Once credibility is lost, it is extremely difficult to restore. The financial press has closely tracked the ongoing tension between Fed chair Jay Powell and President Trump, whose repeated public criticisms have put the institution’s independence under pressure. Powell’s steadfast commitment to the Fed’s mandate underscores why insulating monetary policy from political interference is vital – without that trust, markets and the broader economy become far more vulnerable to instability.

Questions

- 1 Outline why politicians may want to use monetary policy to influence an election.
- 2 Explain what is meant by ‘anchoring’ of inflation expectations and why it is important in terms of setting monetary policy.
- 3 What is meant by the ‘time-inconsistency problem’ in macroeconomics?
- 4 Using a diagram, show how expansionary monetary policy influences the price level and the level of output in the economy.

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