AIER Explainer No. 14
June 2025

What is Central Bank Independence?

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Economists, policymakers, and business leaders widely regard central bank independence as a desirable feature of monetary-institutional design. What is central bank independence, and why is it valuable? How has central bank independence worked in practice? And how should we think about the independence of the United States' central bank, the Federal Reserve ("the Fed")? This explainer answers these questions for interested non-experts.

The explainer begins by defining central bank independence and describing its theoretical desirability. Next, it reviews classic and contemporary studies on how central bank independence affects key macroeconomic variables, particularly inflation. The explainer then discusses the constitutional and legal standing of the Fed and how each relates to central bank independence.

Defining Central Bank Independence

An independent central bank can make monetary policy decisions without direct interference from politicians. Our central bank does not need the president's permission to change its target for the federal funds rate, and it does not need to check with Congress before it conducts open-market asset purchases to increase the money supply. "Independent" is thus a reasonable description of the Fed's day-to-day activities.

There are four kinds of central bank independence. A central bank has *goal independence* if it can choose its own objectives. It has *instrument independence* if it can choose the means for pursuing its goals. It has *financial independence* if it controls its own budget—for example, by being self-funded. And it has *personnel independence* if its chief officers cannot be removed except for cause.

A plausible link exists in economic theory between central bank independence and good macroeconomic outcomes, such as low and stable inflation. Policy is a matter of incentives. If the Fed's monetary policy decisions were under direct political control, politicians might loosen monetary policy in the run-up to elections to bolster their chances of staying in office. Artificially cheap credit and rapid money growth would make the economy look stronger than it is, but the inevitable long-run result is painful inflation, and perhaps even a recession if investors are fooled by low rates into undertaking unsustainable projects. Also, since the Fed can make loans but is not subject to the same profitability constraints as private banks, politicians might use a central bank to steer credit to politically favored, but economically wasteful, causes or projects.

Classic Studies of Central Bank Independence

A large academic literature explores central bank independence. Below are summaries of classic works, as well as more recent investigations. Interestingly, the newer studies are less supportive of central bank independence than the classic studies.

Alex Cukierman, Steven B. Webb, and Bilin Neyapti published a paradigm-defining paper on central bank independence in 1992. They created an index measure of central bank independence, which has been widely used in follow-up studies, and showed that central bank independence correlates with lower inflation in developed countries. This paper set the stage for decades of investigations into the consequences of central bank independence.

A year later, Alberto Alesina and Lawrence Summers showed that increased central bank independence is associated with lower inflation without any harm to real economic performance, as measured by unemployment, GDP growth, and interest rates. This provided additional support for the argument that central bank independence was desirable.

Economists have also interpreted three influential papers, which predate the above studies, as supporting central bank independence. The first two, one by Finn Kydland and Edward Prescott and the other by Robert Barro and David Gordon, show that discretionary (self-chosen) monetary policy has an inflationary bias compared to rule-bound monetary policy. Economists tend to associate period-by-period decisions with politicians on short-term election cycles and a more stable, long-term outlook with central bankers.

The third paper is Kenneth Rogoff's study of monetary policy commitment as embodied in a "conservative" central banker, meaning one who is more hawkish on inflation than the general public. Credibility is key to keeping inflation low. Political control of central banking damages central bank credibility because politicians cannot long diverge from the public's inflation preferences. The less political dependence, the greater the macroeconomic stability.

Recent Studies of Central Bank Independence

Given these articles and their reception, it is unsurprising that central bank independence enjoys strong support among economists and policymakers. But this may be starting to change. Recent studies show that central bank independence does not necessarily lead to better macroeconomic outcomes, especially in terms of price stability.

In 2010, Jeroen Klomp and Jakob de Haan published an important paper showing that "there exists no general significant negative relation" between central bank independence and inflation. Earlier results, while valid, are not robust to alternative estimation methods and newer data.

Daniyar Nurbayev's 2017 article goes even further: the apparent effect of central bank independence on price stability (e.g. low and predictable inflation) is due to broader commitments to the rule of law, rather than central bank independence alone. Notably, "CBI [central bank independence] has no significant effect on price stability when the rule of law is weak."

Cep Anwar published a paper in 2022 focused on central bank independence in developing countries. The effects of central bank independence on inflation are not uniform; the particulars of a country and its government matter more. This may be confirming evidence of Nurbayev's claim that more basic institutional and legal commitments to the rule of law actually explain the correlation between greater central bank independence and lower inflation.

Not all recent studies run against the older consensus. Carola Binder, for example, showed in her 2021 paper that increased political pressure on central banks is correlated with higher inflation and greater inflation persistence. "Even central banks with high legal independence frequently face pressure — nearly always for looser monetary policy," she notes. Empirically distinguishing between (formal) independence and (informal) pressure is a worthwhile endeavor. Of course, political pressure itself has institutional antecedents. Following Binder, the next round of papers will likely attempt to identify these antecedents.

The takeaway is this: the benefits of central bank independence appear to be contingent. Underlying political and economic institutions matter greatly. The conditional benefits of central bank independence should make us hesitant to treat it as a macroeconomic panacea.

Is the Modern Fed Independent?

So how does the US Federal Reserve rank among the four types of independence — goal, instrument, financial, and personnel?

When discussing the independence of the Fed, we need to distinguish between its ordinary operations and its legal standing. It enjoys significant independence in terms of the former, but not the latter.

The Fed has considerable goal independence. It is true that Congress sets the goal as a legislative mandate: currently, a three-part mandate of "maximum employment, stable prices, and moderate long-term interest rates." But the Fed has broad latitude in determining what constitutes success in achieving those goals. The Fed decided on its own that the best way to achieve the goal of stable prices is by adopting a two-percent inflation target.

Similarly, the Fed enjoys a high degree of day-to-day instrument independence. It can use its monetary policy tools, such as setting the target range for the federal funds rate, conducting open-market operations (buying or selling securities), and setting the discount rate (the rate for borrowing directly from the Fed), without consulting elected officials.

The Fed is also financially independent. It funds itself through its monetary policy activities. Its revenues come from returns generated by its asset portfolio. Congress does not currently authorize its funding.

Finally, the Fed has significant personnel independence. It is very difficult to remove the Fed governors or the chair, for example. It is not clear how Congress's impeachment powers apply to the Fed. The president can remove a Fed chair, but only for incompetence or inability to perform essential duties, not for policy disagreements.

Limits of Fed Independence from Congress

Whatever independence the Fed has, however, ultimately depends on Congress. Article I, Section 8 of the Constitution vests in Congress the power "To coin Money, regulate the Value thereof, and of foreign Coin," establishing that monetary policy is ultimately the prerogative of the legislature. Ordinary (operational) independence is best understood as a legislative grant.

The Fed's history bears this out. Congress passed the Federal Reserve Act in 1913 and has since amended it more than 200 times. The Fed's mandate comes from Congress and was last modified in 1977. And many laws, such as Dodd-Frank, enacted structural and procedural reforms. Congress could change the Fed's goals or operating framework again if it wished.

There are also limits to the Fed's personnel independence. The Senate must confirm the president's nominees to the Board of Governors. Most recently, one confirmation failed during President Trump's first term, when economist Judy Shelton did not secure a majority in a full Senate vote. Stephen Moore and Herman Cain, whom Trump also put forward, withdrew their nominations, presumably because they lacked the confirming votes in the Senate. Under President Biden, Sarah Bloom Raskin withdrew her nomination due to opposition from members of the Senate Banking Committee.

Congress could also restrict the Fed's instrument independence if it so chose. Legislators could limit the assets the Fed may purchase (e.g., Treasury debt only) or restrict its lending activities (perhaps even closing the discount window).

As for financial independence, while the Fed is currently self-funding, Congress could make the Fed get its financial resources for non-monetary policy activities (namely, regulation) from the normal appropriations process. Importantly, this would not work for open-market monetary policy. The Fed does not need taxpayer resources to buy or sell assets; it creates or destroys dollar reserves to conduct these operations. Of course, Congress could divert Fed earnings or other balance sheet resources for fiscal purposes, as it did in 2018.

In short, the Fed's independence is a Congressional delegation of power. It lasts as long as Congress pleases and no longer.

Fed Independence from the President

A stronger argument can be made that the Fed is independent from the president. The chief executive nominates Fed governors, but cannot remove them except for cause — something which has never been done. Legal precedent holds that the president can only remove officers who wield purely executive power. Because much of what the Fed does is quasi-judicial (e.g., issuing cease-and-desist orders) and quasi-legislative (e.g., setting reserve requirements for depository institutions), its highest decision-makers enjoy formal protections from the president.

While the Supreme Court recently extended the degree of presidential control over federal personnel, it also exempted the Federal Reserve. The court's majority wrote in support of its order that the Fed is "a uniquely structured, quasi-private entity that follows in the distinct historical tradition of the First and Second Banks of the United States." However, nobody knows what a "distinct historical tradition" means, nor is it well understood why the Fed specifically merits a carve-out. Justice Kagan, for example, was puzzled by the "bespoke Federal Reserve exemption." These ambiguities mean additional court cases could ensue.

Of course, presidents can wield all sorts of *informal* pressure on Fed chairs and governors. Nearly every president since Eisenhower has tried to influence monetary policy decisions. President Nixon (in)famously prevailed upon then-chairman Arthur Burns to loosen monetary policy in the run-up to the 1972 presidential election. Even President Reagan, whom history credits with presiding over America's economic revitalization during the 1980s, was worried about how then-chairman Paul Volcker's battle against inflation would affect his reelection prospects. More recently, during the Biden administration, there is some evidence that the Fed delayed monetary tightening in the wake of rising inflation because Chairman Powell wanted to secure his reappointment over Lael Brainard, a more dovish candidate. Presidential interference with monetary policy more closely resembles the bad-incentives concerns about running the printing press for partisan or electoral reasons than does Congressional oversight.

Independence in the Balance

In the last analysis, monetary policy cannot be independent from elected officials because monetary policymakers answer to Congress. We may wish to insulate central banks from overly ambitious presidents. History shows that chief executives may be willing to sacrifice price stability for political or electoral success. Nevertheless, central bankers still answer to legislators, as the Constitution requires.

Fed watchers in academia, government, and business largely assume the Fed both is and should be independent. The reality is more complicated. As economists Jerry Jordan and William Luther note in a recent study, "The United States ranks in the bottom quartile of countries on several measures of central bank independence." This is by design: Constitutional principles require Congress to oversee any monetary authority to whom Congress delegates power. Furthermore, while economic scholarship has no legal standing, it is important to note that recent studies of central bank independence rarely find unambiguously positive effects.

The Fed's operational independence *de facto* depends on Congress's continued goodwill. Congress controls the Fed *de jure* and can intervene at any time to restrict goal, instrument, financial, or personnel independence.

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