Central Bank Independence

Vasso Ioannidou
(Bayes Business School & CEPR)

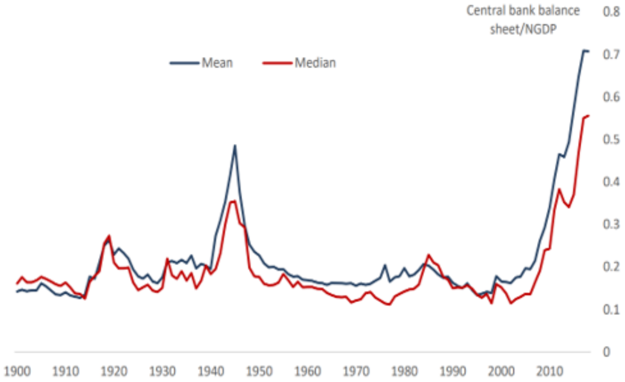
Banca d'Italia
Rome, June 13, 2025

Motivation

- Central banks' primary responsibility is ensuring **monetary stability**.
- Many also have mandates for **financial stability**.
- Post-GFC, financial stability **powers expanded**:
  - E.g., QE, stress tests, and macroprudential tools (LTV ratios, liquidity requirements, dynamic provisions, capital buffers).

Central Banks' Balance Sheets

- Central banks' balance sheets **larger** than ever before.



- Not only larger, but also **riskier**.

Motivation (Cont'd)

- Their powers are expected to expand as they develop policies on **digital currencies** and **climate-related risks**.
- The expanded powers, coupled with global rise in **populism** and **geopolitical uncertainty**, threaten central bank independence.
- Thread **no longer hypothetical** – US President Donald Trump's public attacks on the FED are a stark example.

Motivation (Cont'd)

- Their powers are expected to expand as they develop policies on **digital currencies** and **climate-related risks**.
- The expanded powers, coupled with global rise in **populism** and **geopolitical uncertainty**, threaten central bank independence.
- Thread **no longer hypothetical** – US President Donald Trump's public attacks on the FED are a stark example.
- Important to understand **how far** do past reforms insulate central banks and their agents from political interference.
- Which **frictions** and **design features** matter?

Central Bank Independence (CBI)

Lets set the background first:

- Why do we care about central bank independence?
- What do we mean with central bank independence?

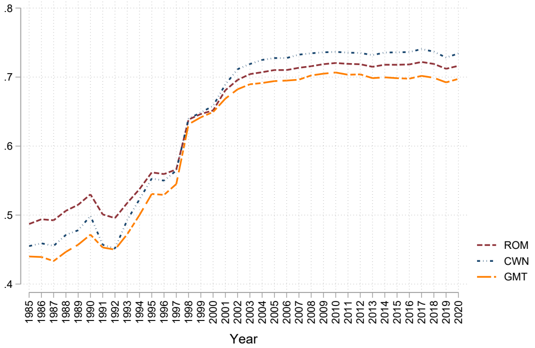
"A multi-faceted and often misunderstood concept" (Haldane, 2020)

The Case for Independence

- In late 1980s, CBI emerged as an institutional solution to time inconsistency problem (Kydland and Prescott, 1977; Calvo, 1978):
  - Shift control of MP away from elected politicians, whose re-election concerns could generate either **inflation bias** or **political cycles** (Barro and Gordon, 1983; Alesina and Roubini, 1992) to unelected **technocrats** or a conservative central banker caring only about inflation.
- This monetary stability argument was used successfully around the world: starting from mid-1990s many countries began reforming the institutional framework governing their central banks to protect them from undue political interference (*de jure* CBI).
- Parallel argument for **financial stability**.

The Rise of de jure CBI

- The rise of *de jure* CBI has been documented by several studies.



ROM: Romelli (2022); CWN: Cuckierman et al. (1992); GMT: Grilli et al. (1991).

De jure CBI components

Definition of de jure CBI

- *"Independence is very rarely* **absolute** *or* **binary** *in any domain of public policy... almost always subject to* **constraints***... ex-ante and* **accountability***... ex-post."* (Haldane, 2020)

Definition of de jure CBI

- "*Independence is very rarely* **absolute** *or* **binary** *in any domain of public policy... almost always subject to* **constraints**... *ex-ante and* **accountability**... *ex-post.*" (Haldane, 2020)
- Legally, CBI can be framed into 4 pillars (Lastra, 2015):
    - **Quasi-constitutional** independence (e.g., through a Treaty)
    - **Institutional** independence (e.g., legal remits and safeguards to perform tasks)
        - Target vs. instrument independence
        - Instrument independence $\approx$ operational independence
    - **Financial & economic** independence (e.g., restrictions on monetizing government debt, sufficient resources)
    - **Personal** independence (e.g., appointment procedures, legal protection to decision-making agents)

But..

De jure CBI $\neq$ De facto CBI

- Laws are incomplete.
- Actual practice may deviate.
- Reforms may give rise to a 'seesaw effect' (Acemoglu et al., 2008) as political process has 'status quo bias' (Fernandez and Rodrik, 1991).

de jure CBI vs. de facto CBI

The 4 pillars of *de jure* CBI:

- Quasi-constitutional independence
- Institutional independence
- Financial & economic independence → Goncharov, Ioannidou, Schmalz (2023)
- Personal independence → Ioannidou, Kokas, Lambert, Michaelides (2025)

Financial Independence

(Why) do central banks care about their profits?

Goncharov, Ioannidou, Schmalz (2023 JF)

This Paper

- This paper offers a first systematic analysis of whether cental banks are concerned about the **level** or **sign** of their **accounting profits**.
- And if so, what are the **drivers** & **consequences** of such concerns.

- Context:
  1. **Absent frictions, CB accounting doesn't matter** (Ricardo, 1821; Barro, 1974; Wallace, 1981; Hall and Reis, 2015).
  2. **In theory, profit concerns lead to credibility problems and deviations in policy** (Barriel and Bhattarai, 2009; Beningo and Nistico, 2016; Del Negro and Sims, 2015).
  3. **Profit concerns can also serve as a commitment device** (Jeanne and Svensson, 2007; Mendes and Barriel, 2015).

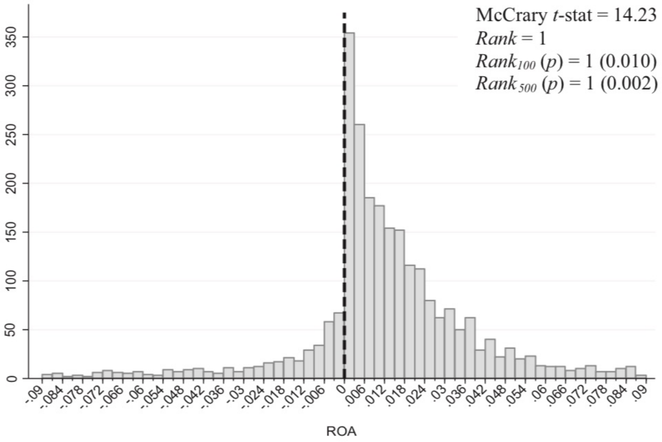
What do we DO?

- **Challenge:** How to measure preference for profits?
  - What is the *counterfactual* profit level?
- **Idea:** Check for a discontinuity in profit distribution at 0.

1. Is there a discontinuity?
2. Which factors drive the discontinuity?
   - Cross-sectional variation in size of discontinuity
3. Is it just accounting, or does it relate to policy?

1. Is there a discontinuity?

Panel A. Distribution of central bank profits



2. Which factors drive the discontinuity? (Summary)

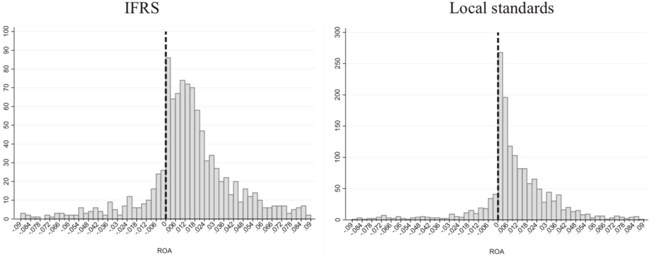
The **size** of the discontinuity varies predictably with central banks' **ability** to their control reported income & **incentives** to avoid losses.

- Ability:
  - Accounting rules (e.g., IFRS vs. local standards).
- Incentives:
  - Populism (e.g., extreme parties).
  - Agency problems (e.g., governor re-appointable).
  - Divided distribution rules (e.g., intertemporal smoothing).

These relations are **unique** to the zero-profit threshold.

Ability: Accounting rules

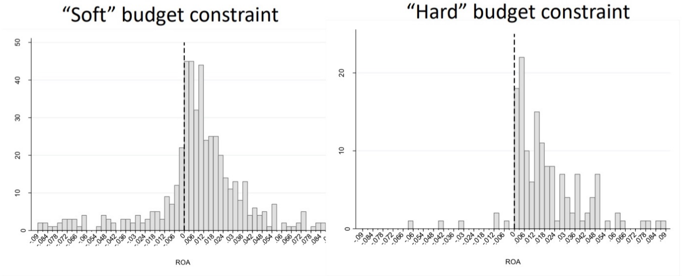
- Discontinuity greater when **accounting** allows for **more discretion**.
- (IFRS less discretion: no general purpose provisions + mark-to-market).



OLS regression for zero-profit threshold			Simulated estimates for placebo thresholds						
N	Constant	Coefficient	Mean constant	Mean coefficient	Rank of the test *t*-stat.	Rank (100)	Percentile rank (100)	Rank (500)	Percentile rank (500)
421	0.768***	0.099**	0.487	0.007	2	3	0.030	10	0.020
	(0.040)	(0.044)	(0.017)	(0.024)					

Incentives: Financial Independence

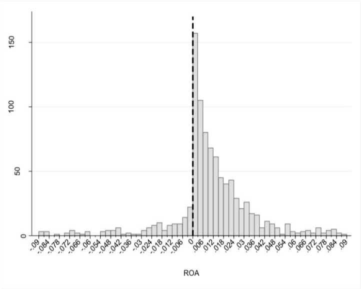
- Discontinuity greater when **dividend distribution rules** do not allow for **intertemporal smoothing** of the CB's budget constraint.



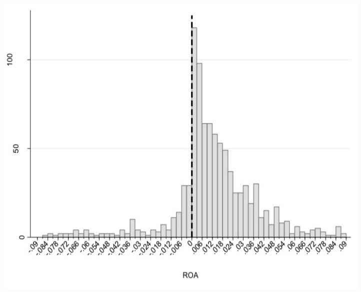
Prevailing incentives	N	Constant	Coefficient	Constant	Coefficient	Rank of the test t-stat	Rank (100)	Percentile rank (100)	Rank (500)	Percentile rank (500)
Dividend distribution rules	85	0.672***	0.328***	0.497	-0.045	1	2	0.020	4	0.009
		(0.058)	(0.058)	(0.026)	(0.084)					

De jure CBI doesn't fix it! (more on this later)

Above median



Below median



Prevailing incentives	N	Constant	Coefficient	Constant	Coefficient	Rank of the test t-stat	Rank (100)	Percentile rank (100)	Rank (500)	Percentile rank (500)
Central bank de jure independence	326	0.803***	0.074*	0.452	0.035	1	4	0.040	14	0.028
		(0.033)	(0.041)	(0.044)	(0.039)					

3. Is this just accounting, or does it relate to policy?

In theory, profit concerns create incentives to **avoid** or **delay** interest rate increases harmful to profitability, leading to higher inflation.

- Bhattarai et al. (2015); Del Negro & Sims (2015); Mendes & Barriel (2015).
- Other non-accounting options: FX interventions, don't bail out banks...

What do we **do**?

- Study **inflation rates** around the 0 profit threshold
  - in absolute terms, relative to targets, relative to professional forecasts.
- Study **interest rates** around the 0 profit threshold.
  - Level of interest rates, controlling for inflation and output gap in Taylor rule type regressions.

3. Is this just accounting, or does it relate to policy?

In theory, profit concerns create incentives to **avoid** or **delay** interest rate increases harmful to profitability, leading to higher inflation.

- Bhattarai et al. (2015); Del Negro & Sims (2015); Mendes & Barriel (2015).
- Other non-accounting options: FX interventions, don't bail out banks...

What do we **do**? **Find?**

- Study **inflation rates** around 0 profit threshold – Higher (1.4 pp)
  - in absolute terms, relative to targets, relative to professional forecasts.
- Study **interest rates** around 0 profit threshold. – Lower (50 bp)
  - Level of interest rates, controlling for inflation and output gap in Taylor rule type regressions.

Key Takeaways

In theory, non-traditional (and traditional) central banking sustainable **IFF** central banks **disregard profits**, feel free to make losses.

Our results suggests that **they don't!**

Discontinuity suggests that losses are **not** (perceived to be) frictionless.

Profit concerns **not independent** of their policy inputs and outputs.

Personal Independence

(In)dependent central banks

Ioannidou, Kokas, Lambert, Michaelides (2025)

This paper

De jure CBI $\neq$ De facto CBI

- One way politicians may seek to retain control is by getting **"their own people"** into the top jobs.
  - "Leaders matter" (Jones and Olken, 2005; Funke et al 2021).
  - "Managers matter" (Bertrand and Schoar, 2003).
  - Preferences and career concerns (Chang, 2006; Adolph, 2013)
- Incentives to do so may be **greater** as *de jure* CBI increases.

Anecdotal evidence is plentiful

"President Donald Trump has demanded that interest rates should be slashed, speculated about firing the boss of the Federal Reserve... India's government has replaced a capable central-bank chief with a pliant insider who has cut rates ahead of an election... Rather than win by force of argument, they are seeking an edge by getting their own people into the top jobs." — The Economist (Apr. 2019)

This paper

- Have central bank governor appointments become **more** or **less political** following central bank independence reforms?
  - **Narrative 1:** (+) correlation
  - **Narrative 2:** (-) correlation

- A **politically-motivated appointment** is one skewed towards candidates more loyal to the executive making the appointment rather than their mandate.

- **Research Questions:**
  1. What of these narratives better describes the data?
  2. Is this description constant across countries and over time?
  3. Does this relate to their policy outcomes?

Paper summary

- **Data & Sample:**
  - Bio, Press, Experts → governor independence (GI) index.
  - 316 governor appointments in 57 countries 1985-2020.

Paper summary

- **Data & Sample:**
  - Bio, Press, Experts → governor independence (GI) index.
  - 316 governor appointments in 57 countries 1985-2020.

- **Results:**
  1. Institutional reforms to improve central bank independence are **not** followed by more independent governor appointments ...
  2. ... if anything appointments have become **more political** as central bank independence increased.
  3. Political appointments correlate positively with measures of **de facto CBI** (experts & early dismissals).
  4. Political appointments correlate positively with **inflation rates**, **sovereign debt crises**, and **bond yields** ↑.

GI Index

1. **Biographical**
    - Employment ties (e.g., Minister of Finance)
    - Ideological ties (e.g., party membership)
    - Personal ties (e.g., family, friendship)
2. **Press**
    - Factiva search
    - All major English-speaking newspapers
    - 3 months around appointment
    - Overall tone of the press: Yes/No
3. **Experts**
    - Specialization in Macro or Finance
    - Affiliation with a university, national research and policy institution (not a central bank)
    - With >2 decades of experience
    - With or without Anglo-Saxon training
    - RePEc database & lists of NBER and CEPR
    - Sent to 587 academics (on average 10 per country)
    - 289 responses (3 to 8 per country)

Experts: Survey

- Each academic received a survey specific of their country of origin.
- Same 2 questions for each governor:
  - In your opinion, at the **time of the appointment**, was [...] a politically independent central bank governor?
  - In your opinion, **with the benefit of hindsight**, was [...] a politically independent central bank governor?
- **Answers:** "Yes", "No", or "I do not know" (+ comment).
- Construction of balance statistic [-1,1] to determine political interference (Pesaran and Weale, 2006).

Baseline GI index

The 3 criteria are combined as:

$$GI_{i,t} = \frac{1}{n} \sum_{j=1}^{n} C^j_{i,t},$$

$C^j_{i,t}$ equals 1 if appointment i at t is independent according to criterion j (out of n) and 0 otherwise.

Higher values $\rightarrow$ higher independence.

	N	Mean	SD
Criteria			
Executive ties	292	0.442	0.497
International press	316	0.630	0.480
Independent experts	293	0.611	0.488
Index			
GI index	257	0.499	0.252

Alternatives:

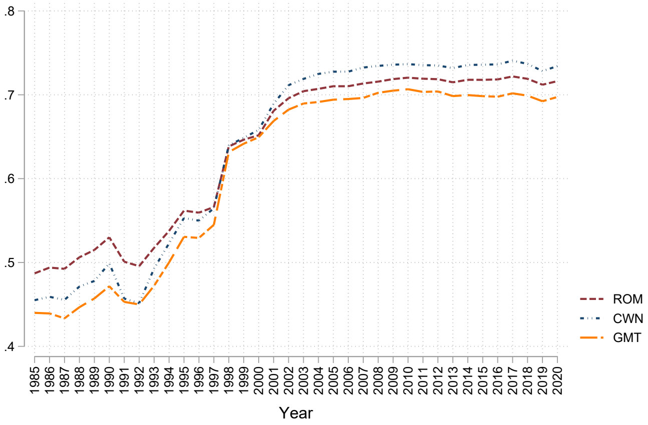
- **GI Lexi** $=$ 1 if executive ties, succession, press, and experts **all** $= 1$
  (Bade and Parkin, 1988; Adrian, Khan, and Menand, 2024, for de jure).
- **GI PCA** $=$ principal component of underlying criteria.

Results roadmap

1. Have governor appointments become less political as *de jure* CBI $\uparrow$?
2. Are political appointees associated with worse policy outcomes?

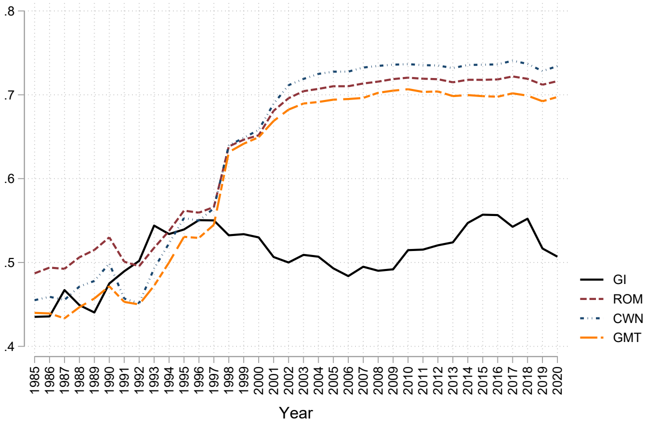
De jure CBI & GI: Visual illustration

- **De jure** CBI ↑



De jure CBI & GI: Unconditional

- **De jure** CBI ↑, but GI does not follow, if anything ↓ until GFC



De jure CBI & GI: Conditional

No relation btwn *de jure* CBI & GI or any of its components.

	(1)	(2) GI index	(3)	(4) Executive Ties	(5) Press	(6) Experts	(7) GI Lexi	(8) GI PCA
De Jure CBI	**-0.135**	**-0.237**	**0.063**	**0.111**	**-0.014**	**0.093**	**0.062**	**0.005**
	[-0.857]	**[-1.474]**	**[0.313]**	**[0.445]**	**[-0.063]**	**[0.360]**	**[0.217]**	**[0.038]**
Other governor & country characteristics		YES	YES	YES	YES	YES	YES	YES
Country FE			YES	YES	YES	YES	YES	YES
Observations	251	223	222	222	222	222	255	221
R-squared	0.005	0.122	0.468	0.397	0.441	0.567	0.359	0.443

Personal Independence

Same also wrt reforms that safeguard **personal independence**.

	(1)	(2)	(3)
Dependent variable:	GI	GI Lexi	GI PCA
De Jure CBI_Governance	**0.050**	**0.179**	**-0.049**
	[0.257]	**[0.694]**	**[-0.400]**
Other governor & country characteristics	YES	YES	YES
Country FE	YES	YES	YES
Observations	222	255	221
R-squared	0.468	0.361	0.443

A "Seesaw effect"

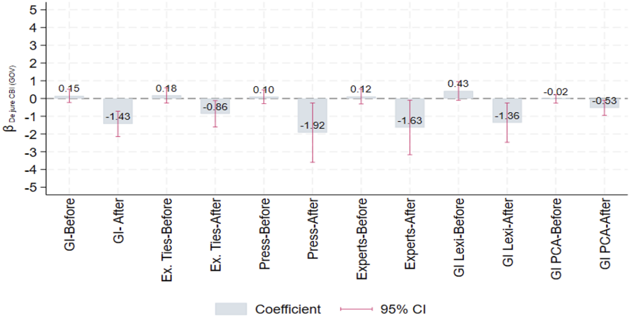
Incentives to **"undo"** independence with political appointees $\uparrow$ as CBs & decision-making agents insulated from political pressure.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
		GI Index			Executive Ties	Press	Experts	GI Lexi	GI PCA
Policy Independence	1.014***	0.746***	1.105***	0.625**	0.087	1.264*	0.613	0.613	0.139
	[4.585]	[11.345]	[7.210]	[2.151]	[0.284]	[1.794]	[0.869]	[1.222]	[0.821]
De jure CBI_Governance x Policy Independence	**-1.874*** **	**-1.680*** **	**-2.274*** **	**-1.584*** **	**-1.039** **	**-2.025** **	**-1.751* **	**-1.791** **	**-0.508* **
	[-7.052]	**[-29.545]**	**[-9.530]**	**[-3.597]**	**[-2.360]**	**[-2.060]**	**[-1.910]**	**[-2.601]**	**[-1.869]**
De jure CBI_Governance	0.170	0.269	0.265	0.152	0.178	0.102	0.117	0.428	-0.018
	[0.975]	[1.327]	[1.174]	[0.671]	[0.696]	[0.443]	[0.463]	[1.355]	[-0.125]
Country FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
Other governor & country characteristics		YES	YES	YES	YES	YES	YES	YES	YES
Observations	250	226	226	222	242	255	234	255	221
R-squared	0.397	0.406	0.426	0.503	0.449	0.453	0.568	0.396	0.461

External constraints (IMF & EU accession) mitigate.

A "Seesaw effect": Visual

Relationship btwn de jure CBI & GI becomes **strongly negative** after CB given operational independence.



Results roadmap

1. Have governor appointments become less political as *de jure* CBI $\uparrow$?
2. Are political appointees associated with worse policy outcomes?

Inflation during tenure

- GI has more explanatory power than *de jure* CBI.
- GI retains significance even after we control for other governor characteristics (i.e., education, experience).

	Average Inflation During Tenure (log)					
	(1)	(2)	(3)	(4)	(5)	(6)
GI Index	**-0.711****	**-0.752****	**-0.877*****	**-0.734****	**-0.934****	**-1.017****
	[-2.068]	**[-2.156]**	**[-2.629]**	**[-2.159]**	**[-2.195]**	**[-2.086]**
De jure CBI		-1.562***	-0.638	-0.589	-0.736	0.557
		[-2.731]	[-1.241]	[-1.121]	[-1.293]	[0.800]
Government stability			-0.304***	-0.274***	-0.274***	-0.268***
			[-4.542]	[-4.076]	[-4.107]	[-4.065]
Predecessor early departure			0.933***	0.844***	0.827***	0.625***
			[4.339]	[3.870]	[3.794]	[2.842]
IMF program			-0.206	-0.498	-0.280	-0.419
			[-0.635]	[-1.635]	[-0.784]	[-1.212]
GI Index*Inflation Target					1.031*	1.192*
					[1.659]	[1.837]
Inflation Target					-0.947**	-1.370***
					[-2.297]	[-3.118]
GI Index*Eurozone						0.458
						[0.656]
Eurozone						-1.886***
						[-3.241]
Decade FE			YES	YES	YES	YES
Other governor characteristics				YES	YES	YES
Obs	266	243	219	215	215	215
R-square	0.021	0.052	0.223	0.283	0.296	0.363

Other outcomes & market expectations

- More independent appointees are less likely to experience a **sovereign debt crisis** during their tenure.
- **No difference** wrt to banking crises or currency crises.
- **GI** $\uparrow \rightarrow$ **Bond Prices** $\uparrow$
    - [-5,+5] days window.
    - 2-year government bonds.

Key Takeaway

- Our results indicate that incentives to **"undo"** CBI through **political appointments** increase as *de jure* CBI increases.

- These incentives **not independent** of key **policy outcomes**.

Conclusions

- **Legal independence isn't enough** — practice often deviates.
- **Profit concerns matter** — affecting policy decisions.
- **Appointments remain political** — even after reforms.
- **Political influence persists** — through backdoor channels.