Central bank independence – why it matters

Speech honouring Otmar Issing on his 90th birthday

23.04.2026 | Frankfurt/Main | Joachim Nagel

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1 Introduction

Ladies and gentlemen, Welcome to this colloquium in honour of Otmar Issing's 90th birthday!

Dear Otmar Issing, congratulationson this remarkable milestone. Today is a beautiful day to celebrate your birthday here in Frankfurt. We are delighted to welcome you back to the Bundesbank, the place where your journey as a central banker began. Even though we are not exactly in Wilhelm-Epstein-Strasse right now.

When you joined the Bundesbank in 1990, you came with a sharp mind and a firm belief: central banks should be independent. Not only did you advocate for this principle. You embedded it in the DNA of the Eurosystem.

As the ECB's first Chief Economist, you played a key role in designing a framework that balanced rules with flexibility, ensuring price stability without stifling growth. You took the Bundesbank's tradition of independence and made it Europe's.

But your legacy goes beyond policy. After your career as an active central banker, you continued to shape international discussions – through your writing, your teaching, and your leadership at the Center for Financial Studies. You never shied away from the hard questions – and you always demanded rigorous answers.

Over the last decade, you warned repeatedly against overburdening central banks with too many tasks and obligations. You saw the risk that this might ultimately erode their independence and weaken their ability to deliver on their mandate of price stability.[1]

Today, we are seeing attacks on central bank independence around the world – from Jakarta to Istanbul, from Caracas to Washington. So, the topic of this colloquium in your honour could not be more fitting: Achieving and maintaining central bank independence – why it matters.

To ground our discussion, my speech will focus on a fundamental question: What evidence do we have that independence delivers on its promise to keep inflation low and stable? I will proceed in three steps:

First, I will briefly recall the theoretical rationale for central bank independence.

Second, I will discuss the early and more recent empirical literature on the relationship between central bank independence and inflation.

Third, I will present new Bundesbank research that analyses the impact of the recent attacks on the independence of the Federal Reserve.

2 Central bank independence and inflation: theoretical underpinnings

Let me start with the theoretical rationale for central bank independence. Why did many central banks fail so spectacularly to control inflation during the energy crisis of the 1970s?

Economists identified a structural shortcoming in the monetary framework: central banks were too vulnerable to political pressure. The solution: protect monetary policy from politics – through central bank independence.

In Germany, – as those familiar with the Deutsche Bundesbank would dryly note – this has been "established practice since August 1957". Back then, this principle was far from universal.

The two main papers commonly cited as supporting the idea that central bank independence could help lower inflation were actually written without this specific idea in mind.

An important contribution that underpins the idea that central bank independence could help control inflation came in 1977. Kydland and Prescott identified a fundamental flaw in discretionary policy: time inconsistency.[2] Their insight was simple but profound.

Policymakers often face a dilemma: a plan that seems optimal today may no longer be optimal tomorrow. The reason for this is that once private actors have adjusted their behaviour in response to the plan, policymakers have an incentive to break their promise.

Private actors anticipate that policymakers will be tempted to deviate from their initial plan. And because of that, these private actors do not fully believe the announced plan in the first place and adapt their behaviour accordingly. "Fool me once, shame on you; fool me twice, shame on me" comes to mind here.

The result: policymakers end up with a worse outcome than if they had been able to commit in advance to their plan and stick to it. That is the logic of time inconsistency in a nutshell.

In 1983, Barro and Gordon applied this insight to monetary policy – and identified the classic inflation bias.[3] In their model, the policymaker wants to push output above its natural rate by generating surprise inflation.

But again, the rational public are not fooled – they anticipate this incentive. And as a result, the economy ends up with no lasting output gains, just higher trend inflation – the classic inflation bias. Barro and Gordon argued that central banks can escape the inflation bias and secure low and stable inflation by constraining their discretion through rules or reputation.

A first concrete institutional proposal to address this challenge came from Rogoff in 1985. He suggested delegating monetary policy to an inflation-averse, "conservative" central banker.[4]

More generally, the solution to the inflation bias was to insulate monetary policy from short-term political pressure. The institutional fix: an independent central bank focused on delivering low and stable inflation.[5]

These contributions on time inconsistency and delegation were largely abstract and not focused on the Bundesbank. However, the Bundesbank quickly became a central empirical and policy reference point in the debate. It was widely portrayed as a successful example of an independent central bank delivering low inflation.[6]

3 Central bank independence and inflation: empirics

3.1 Early contributions

At the start of the 1990s, economists tested the hypothesis that central bank independence lowers inflation empirically.[7]

Alesina and Summers examined sixteen OECD countries and found that higher central bank independence is indeed associated with lower average inflation and less inflation variability.[8] Moreover, lower and more stable inflation did not come at the cost of weaker or more volatile economic growth.

They measured central bank independence with an index that combines political and economic dimensions. Political independence means the central bank can fulfil its policy objectives without government interference. Economic independence means the central bank can use its instruments without restrictions. This index reflects the central bank's legal framework and is thus a measure of legal independence.

Cukierman, Webb, and Neyapti included emerging and developing economies in their analysis, using a refined measure of legal independence.[9] They also found empirical evidence that in advanced economies higher independence goes hand in hand with lower and more stable inflation. However, they could not find this relationship for emerging and developing countries.

How is that? The authors argue that legal independence and actual independence are two different things. And both are needed for central banking to be effective. When Cukierman and co-authors used a proxy for actual independence – the turnover rate of central bank governors – the negative relationship reappeared.[10]

This is one early key lesson and will guide my remarks going forward: legal independence reduces and stabilises inflation only when backed by actual independence.

3.2 Addressing endogeneity and heterogeneity

Let me now turn to how the literature has evolved since the 1990s – from simple correlations to more rigorous tests of causality.

Reflecting the econometric tools prevalent in the late 1980s, the early studies mainly documented cross-sectional correlations. Since then, researchers have used more advanced empirical methods to reassess the relationship in depth. The key issue they addressed is endogeneity – an econometric problem that can influence estimates of central bank independence's effect on inflation.

For example, inflation outcomes and central bank independence may be jointly determined by an unobserved factor – such as a societal preference for low inflation. This can make it seem like independence causes lower inflation when other factors are at play.

A key critique in this regard came from Adam Posen in the mid-1990s, then at the New York Fed.[11] He argued that central bank independence is not a random choice by politicians. Instead, it reflects the fact that financial market participants typically oppose high inflation. This implies that both independence and low inflation may result from the same underlying factor: a societal preference for price stability.

More generally, his point is that a central bank with a mandate for price stability needs broad societal support – from politicians, financial markets, and the public. Central bank independence is thus one ingredient for low and stable inflation, but not the only one.[12]

Or, as Otmar Issing framed it in 1993: central bank independence is a necessary condition for price stability, but by no means sufficient.[13]

Subsequent work refined and extended this idea, emphasising how political institutions and constraints shape the effect of independence on inflation.[14] Taken together, these contributions suggest that the simple formula "make the central bank independent and low and stable inflation will follow" is incomplete.[15]

Yet they do not overturn the core finding: central bank independence contributes to lower inflation.[16] This holds even in most studies that rigorously address endogeneity.[17] The effect is often smaller once this potential bias is accounted for, though it remains statistically and economically significant. Moreover, the effect varies across countries – reflecting differences in institutions, politics, and economic structures.[18]

A good example that illustrates that heterogeneity is at play is a recent study by Ioannidou and co-authors.[19] They argue that while legal independence has strengthened in many countries since 1980, the appointment of central bank governors has become more politicised. These politically motivated appointments reduce actual independence. And this weakens the relationship between legal independence and inflation, resulting in worse inflation outcomes.

3.3 Conclusions from the literature

So, overall, what does the literature ultimately teach us? My takeaway is clear: central bank independence remains crucial for price stability.

The theoretical case for central bank independence still holds. Furthermore, recent empirical work confirms that greater independence is linked to lower inflation – though the effect is nuanced. More specifically, I think the literature identifies three conditions for central bank independence to provide price stability:

First, legal independence: The central bank needs legal protections that shield it from political interference.

Second, actual independence: The central bank needs leaders committed to price stability who actively use their authority to resist pressure.

Third, broad societal support: The central bank needs backing from a broad consensus – among politicians, financial markets, and the public – that price stability is desired. Needless to say, politicians must support price stability with sustainable fiscal policies.

Already twenty years ago, a visionary central banker – then a remarkably youthful 70-year-old – reached a similar conclusion. Let me quote:

"Theory and practice have confirmed the importance of an appropriate institutional framework for the central bank based on independence and a clear focus on price stability [...]. It must however also be recognised that the "stability" culture of society also matters".[20]

This quote is, of course, yours, Otmar. It captures a truth that remains as relevant today as it was then.

4 Recent threats to central bank independence

Because today we see what happens when that stability culture weakens – and when political leaders turn against central bank independence.

A striking example are the attacks on the Federal Reserve since early 2025. As the Fed's actions shape global financial conditions, these attacks matter – not just for the United States, but for all of us.

Have these attacks achieved their intended goal? And what do they mean for the Fed's independence? New research by two Bundesbank economists – Ivan Frankovic and Sören Karau – can shed light on these questions.[21]

Their study examines how President Trump's political pressure on the Fed affects financial markets. More specifically, they identify "Fed pressure shocks" based on President Trump's social media posts and selected press reports since his return to office in 2025.

They use high-frequency changes in US Treasury yields, equity prices, gold prices, and the US dollar-euro exchange rate around those posts to construct measures of "Fed pressure". These measures then feed into their statistical model, allowing the authors to estimate how markets respond to these shocks over time.

So, what do they find? The results are striking.

When pressure rises, Treasury yields fall, suggesting markets expect looser monetary policy. Yet equity prices do not increase as one would expect. Instead, they fall and volatility increases. Furthermore, gold prices surge, and the US dollar weakens particularly strongly.

The authors interpret this as a risk repricing on two levels: First, within US markets, investors shift from equities to Treasuries – a domestic flight to safety. Second, the weaker dollar and higher gold prices show investors pulling away from US assets – a flight to safety outside the United States.

Importantly, the paper finds no evidence that inflation expectations rise. In fact, market-based measures decline slightly, if anything.

This suggests that investors are not simply expecting easier monetary policy – they are worried about the integrity of US institutions and the far-reaching consequences that a loss of integrity would entail. Or, put differently, concerns about weaker US growth or higher uncertainty seem to outweigh fears of inflation.

The main takeaway is clear: when markets believe political pressure is undermining the Fed's independence, this triggers a flight from US assets and the dollar. This channel differs from the mechanisms emphasised in earlier literature on Fed pressure during Trump's first term, suggesting that these recent attacks were more severe.[22]

Yet it serves as a fresh reminder: attacks on central bank independence backfire.

Taken together, recent events and the cited literature remind us of a hard truth: Central bank independence is not self-sustaining. It requires people willing to fight for it.

5 Conclusions

Ladies and gentlemen, Otmar Issing is one of these people.

He has been a watchful observer of the central banking world for more than 60 years. He has shaped the way central banking works in the euro area. And he regularly stands up for central bank independence.

62 years ago, he published his dissertation on monetary problems in economic policy in the European Economic Community. For 16 years, he played a major role in shaping monetary policy in Germany and the euro area. He has received so many prestigious awards over the years that to list them all here would really put the audience‘s patience to the test.

Otmar Issing is cosmopolitan and well-read – which will come as no surprise for most people in this room. What some of you may not know is that he studied classical philology some 72 years ago.

As Goethe says in “Hermann and Dorothea” – a quintessential work of Weimar Classicism: “Die rüstige Jugend verspricht ein glückliches Alter” or, translated into English: “A vigorous youth promises a happy old age.”

On that note, Otmar, I wish you many more happy years to come: ad multos annos!

Footnotes:

1. See Issing, O. (2017), Central banks – are their reputations and independence under threat from overburdening?, International Finance, Vol. 20(1), pp. 92–99; Issing, O. (2021), Central Banks – independent or almighty?, SAFE Policy Letter No 92 as well as Issing, O. (2025), How Central Banks Jeopardized Their Independence, Project Syndicate.
2. See Kydland, F and E. Prescott (1977), Rules rather than discretion: The inconsistency of optimal plans, Journal of Political Economy, Vol. 85(3), 473–492.
3. See Barro, R. and D. Gordon (1983), Rules, discretion and reputation in a model of monetary policy, Journal of Monetary Economics, Vol. 12(1), pp. 101–121.
4. See Rogoff, K. (1985), The Optimal Degree of Commitment to an Intermediate Monetary Target, Quarterly Journal of Economics, Vol. 100(4), pp. 1169–1189.
5. See Cukierman, A. (1992), Central Bank Strategy, Credibility, and Independence: Theory and Evidence, MIT Press.
6. See Debelle, G. and S. Fischer (1994), How independent should a central bank be?, Working Papers in Applied Economic Theory Vol. 05, Federal Reserve Bank of San Francisco.

7. An even earlier contribution is Bade, R. and M. Parkin (1988), Central Bank Laws and Monetary Policy, unpublished manuscript.
8. See Alesina, A. and L. Summers (1993), Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence, Journal of Money, Credit and Banking, 1993, Vol. 25(2), pp. 151–62. This paper builds on a seminal contribution on the relationship between institutions and policymaking by Grilli, V., D. Masciandaro, G. Tabellini, E. Malinvaud and M. Pagano (1991), Political and Monetary Institutions and Public Financial Policies in the Industrial Countries, Economic Policy, Vol. 6(13), pp. 341–392.
9. See Cukierman, A., S. Webb and B. Neyapti (1992), Measuring the Independence of Central Banks and Its Effect on Policy Outcomes, The World Bank Economic Review, World Bank, Vol. 6(3), pp. 353–398.
10. Measuring actual independence by the turnover ratio is not without critiques, as causality is difficult to evaluate: Is inflation high because of political interference or are central bank governors removed from office because inflation is too high? See, for example, Dreher, A., J. Sturm and J. de Haan (2008), Does high inflation cause central bankers to lose their job? Evidence based on a new data set, European Journal of Political Economy, Vol. 24(4), pp. 778–787.
11. See Posen, A. (1995), Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence, NBER Macroeconomics Annual, Vol. 10, pp. 253–274. For a critical account of his argument, see de Haan, J. and G. van 'T Hag (1995), Variation in Central Bank Independence across Countries: Some Provisional Empirical Evidence, Public Choice, Vol. 85(3/4), pp. 335–351.
12. For an early empirical assessment that directly tests the relative contribution of central bank independence and other determinants on inflation performance, see Campillo A. and J. Miron, Why Does Inflation Differ across Countries?, NBER Chapters, in: Reducing Inflation: Motivation and Strategy, pp. 335–362.
13. See Issing, O. (1993), Central Bank Independence and Monetary Stability, Institute of Economic Affairs, Occasional Paper 89.
14. See, for example, Keefer, P. and D. Stasavage (2003), Checks and Balances, Private Information, and the Credibility of Monetary Commitments, International Organization, Vol. 56(4), pp. 751–774; Acemoglu, D., S. Johnson, P. Querubin and J. Robinson (2008), When Does Policy Reform Work? The Case of Central Bank Independence, Brookings Papers on Economic Activity, Vol. 39(1), pp. 351–429 as well as Daunfeldt, S. and X. de Luna (2008), Central Bank Independence and Price Stability: Evidence from OECD-Countries, Oxford Economic Papers, Vol. 60(3), pp. 410–422.

15. For an early assessment along these lines, see Eijffinger, S. and J. de Haan (1996), The Political Economy of Central-Bank Independence, Princeton Studies in International Economics 19.
16. See, for example, Berger, H., J. De Haan and S. Eijffinger (2001), Central bank independence: an update of theory and evidence, Journal of Economic Surveys, Vol. 15(1), pp. 3–40; Crowe, C. and E. Meade (2007), The Evolution of Central Bank Governance around the World, Journal of Economic Perspectives, Vol. 21(4), pp. 69–90 as well as Klomp, J. and J. de Haan (2010), Inflation And Central Bank Independence: A Meta-Regression Analysis, Journal of Economic Surveys, Vol. 24(4), pp. 593–621. For a more critical account of the literature, see Hayo, B. and C. Hefeker (2002), Reconsidering central bank independence, European Journal of Political Economy, Vol. 18(4), pp. 653–674.
17. See, for example, Crowe, C. and E. Meade (2008), Central bank independence and transparency: Evolution and effectiveness, European Journal of Political Economy, Vol. 24, pp. 763–777; Brumm (2011), Inflation and central bank independence: Two-way causality?, Economics Letters, Vol. 111, pp. 220–222 as well as Agur, I. (2021), Central bank independence and low inflation: who leads the dance?, Applied Economics Letters, Vol. 28(6), pp. 477–481. Crowe and Meade (2008) use instrumental variable estimations and find robust evidence that greater central bank independence is associated with lower inflation. Brumm (2011) shows that inflation and central bank independence are endogenously determined, yet the negative correlation between the two remains robust. Agur (2021) finds that for advanced economies, central bank independence reform is found to significantly lead disinflation, while there is no Granger causality in the opposite direction.
18. For a study that explicitly allows for parameter heterogeneity across countries, see Klomp, J. and J. de Haan (2010), Central bank independence and inflation revisited, Public Choice, Vol.144, pp. 445–457. They find that central bank independence has a significant effect only in a minority of the more than 100 countries in their sample. Papers that split their samples between advanced and developing economies include Kokoszczyński, R. and J. Mackiewicz-Łyziak (2019), Central bank independence and inflation – Old story told anew, International Journal of Finance and Economics, Vol. 25(1), pp. 72–79 and Lim (2021), The limits of central bank independence for inflation performance, Public Choice, Vol. 186, pp. 309–335. Whereas Kokoszczyński and Mackiewicz-Łyziak (2019) only find a significant relationship between central bank independence and inflation for developing economies, Lim (2021) comes to the opposite result, and only finds it for advanced economies.

19. See Ioannidou, V., S. Kokas, T. Lambert, and A. Michaelides (2025), (In)dependent central banks, Available at SSRN: Ioannidou, Vasso and Kokas, Sotirios and Lambert, Thomas and Michaelides, Alexander, (In)dependent Central Banks (October 31, 2022). Available at SSRN: https://ssrn.com/abstract=4262695.7
20. Issing, O. (2006), Central Bank Independence – Economic and Political Dimensions, National Institute Economic Review, Vol. 196, pp. 73–74.
21. See Frankovic, I and S. Karau (2026), Political Pressure on the Fed – Is This Time Different?, mimeo.
22. For evidence on Trump's first term, see Bianchi, F., R. Gómez-Cram, T. Kind and H. Kung (2023), Threats to central bank independence: High-frequency identification with twitter, Journal of Monetary Economics, Vol. 135(C), pp. 37–54. For a more general account of the impact of political pressure on the Federal Reserve, see Drechsel, T. (2025), Political Pressure on the Fed, accepted for publication at the Review of Economic Studies.