BanRep Blog: Central Bank Independence and Inflation

Publication date Tuesday the 5th of May, 2026

A common feature of modern central banks is their independence from the government. This autonomy is justified because the goals of the government and the central bank can differ. Typically, governments prioritize short-term growth and therefore favor low interest rates to boost demand and ease debt financing, even if this, in the long term, leads to higher inflation and may harm economic growth. On the other hand, central banks with macroeconomic stability mandates have an interest in low, predictable inflation that ensures the highest possible long-term growth. An environment characterized by high and volatile price increases complicates companies' decisions about how much to invest and in which sectors of the economy to produce, with a consequent adverse impact on long-term economic growth.

The 2023 book *Ensayos de historia económica. Cien años del Banco de la República* (Transl: Essay on Economic History. One Hundred Years of *Banco de la República*), published by the Bank for its centenary, features a chapter by Luis Jácome and Samuel Pienknaugura. They examine the evolution of central bank independence and inflation across Latin American countries. Their analysis uses a central bank independence index (CBI), which can be calculated for any country at any given time.

This CBI index weights four variables identified in the economic literature to assess central bank independence: (i) the legal mandate of the policy objective; (ii) the governance structure of the central bank and its formal independence; (iii) the powers to control monetary policy vis-à-vis the government; and (iv) the conditions for financing public expenditure by the central bank. A central bank with a clear legal mandate for price stability, formal independence (in law and the Constitution), the ability to autonomously control monetary policy, and no role in financing the government's budget through money issuance is largely correlated with greater independence and a better position to maintain a low inflation rate. Consequently, the higher the index, the greater the central bank's independence.

Graph 1, taken from the relevant chapter, illustrates the relationship between the average CBI independence index and the average annual inflation rate for a sample of 17 Latin American countries from 1922 to 2021. It reveals a negative relationship between the central bank independence index and inflation. Namely, countries with higher indices of central bank independence have lower inflation. A more detailed statistical analysis based on individual country data confirms this negative relationship.

Graph 1: Inflation1 and Central Bank Independence in Latin America (1922-2021)

Source: Central bank legislation: central bank mandates, amendments to relevant laws, and constitutional provisions. Inflation: international financial statistics and IMF World Economic Outlook, year-end data.

The authors identify three key historical periods in the data, as shown in the Graph. The first period, which extends from 1922 to 1945, is characterized by adherence to the gold standard, which maintained monetary policy independent from the government and kept inflation relatively low. The second, labeled "growth-focused", lasted until 1990, during which central bank independence gradually declined, resulting in high inflation and hyperinflation in some countries. The final period, starting after 1990 and called "stabilization", saw a significant increase in central bank independence and a drop in inflation to low, stable levels, except for the global inflation spike following the pandemic.

Overall, the assessment results corroborate the strong correlation between central bank independence and low inflation. This aligns with economic theory and should serve as a basic tenet in shaping the country's economic policy institutions.

1 ? Inflation is measured as the average of the logarithms of countries' inflation rates, using *log(inflation + 1)*. A logarithmic scale helps with visualization, especially since over several years, many countries in the sample saw annual inflation rates exceeding 1000%. .

Relevant Economic Concepts

- Inflation
  - It is the widespread and sustained increase in the prices of the goods and services most representative of household consumption in a country.
- Intervention interest rate
  - It is the interest rate at which *Banco de la República* lends to or borrows from financial institutions, generally for a one-day term. This rate is B*anco de la República*'s main policy instrument.
- Short and long term
  - While there is no single economic definition of short- and long-term, short-term typically refers to periods shorter than a year, sometimes up to two years. It is characterized by factors that are not fully adjustable, such as capital, labor, and technology, along with rigid prices and wages. Long-term generally refers to periods longer than three years and involves flexible factors of production, including prices and wages.
- Monetary policy
  - A series of decisions by the central bank, using various tools at its disposal, such as the interest rate, to control the amount of money in the economy and thus maintain price stability and ensure the proper functioning of the economy.

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Related Questions and Answers

Why is it important for a central bank to be independent?

The independence of the central bank is important because its objectives differ from those of the government. While the government seeks higher short-term growth and is willing to tolerate higher inflation to achieve it, the central bank aims to keep inflation low and stable, thereby supporting higher, more sustainable long-term growth.

How does central bank independence help control inflation?

An independent central bank focuses on the macroeconomic stability objectives set out in the legislation without interference from the government's short-term objectives. Independence also enhances the Bank's credibility by enabling society to expect a stable macroeconomic environment in the future, which is the foundation for sustainable economic growth. Government interference in monetary policy causes instability, which adversely impacts investment and hiring decisions that support the country's economic growth.

Why do the government’s and the central bank’s interests differ?

Governments often prioritize short-term economic growth during their terms in office, even if it raises inflation. Conversely, central banks aim for macroeconomic stability, meaning low and stable inflation. Maintaining this stability enables companies to make better-informed decisions regarding investments and production, ultimately supporting sustainable long-term economic growth.

Why is high and volatile inflation detrimental to a country’s economy?

Rapid and unpredictable price increases make it harder for companies and individuals to decide how to invest, produce, and save, which negatively affects economic growth and job creation.

What is the Central Bank Independence Index (CBI) and what does it measure?

The CBI is an indicator used to measure a central bank’s independence by evaluating four key features: the central bank’s legal mandate, its governance structure and formal independence, its ability to conduct monetary policy without government interference, and its power to finance (or not) government spending by issuing money. The higher this index, the greater the central bank’s independence.

What does the Latin American experience illustrate regarding central bank independence?

The historical data show that countries with more independent central banks have had lower inflation. Conversely, countries with more limited independence experienced high inflation, including hyperinflation rates exceeding 1000% per year.

Fuente: https://d1b4gd4m8561gs.cloudfront.net/en/blog/central-bank-independence-inflation