

The Future of the Fed: Central Bank Independence and Fiscal Dominance

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Central Bank Independence

- Consensus among economists it that central bank independence is essential to Fed's effective stewardship of the economy.
- Congress mandates Fed's objectives: maximum employment and price stability.
- Federal Reserve has “instrument independence”: determines monetary policy settings based on data and analysis free of political pressure.
- Fed is accountable to Congress. Reports regularly on progress toward mandated goals.
- Establishes legitimacy and public support by explaining its decisions to the American people.

Monetary Dominance vs. Fiscal Dominance

- **Monetary Dominance Regime**

- The central bank focuses on its inflation and employment goals
- Fiscal authorities adjust taxes and spending to maintain debt sustainability.
- Fiscal authorities finance deficits by issuing debt to the market at prevailing interest rates.

- **Fiscal Dominance Regime**

- Government debt and deficits are so large or politically sensitive that:
 - Monetary policy is expected to help contain debt service costs, or:
 - Central bank balance sheets are used primarily to absorb government debt.
- Fed is not fully free to set interest rates and manage its balance sheet to achieve its price stability and maximum employment objectives.
- Markets believe that price stability is secondary to fiscal accommodation.

The Dangers of Fiscal Dominance

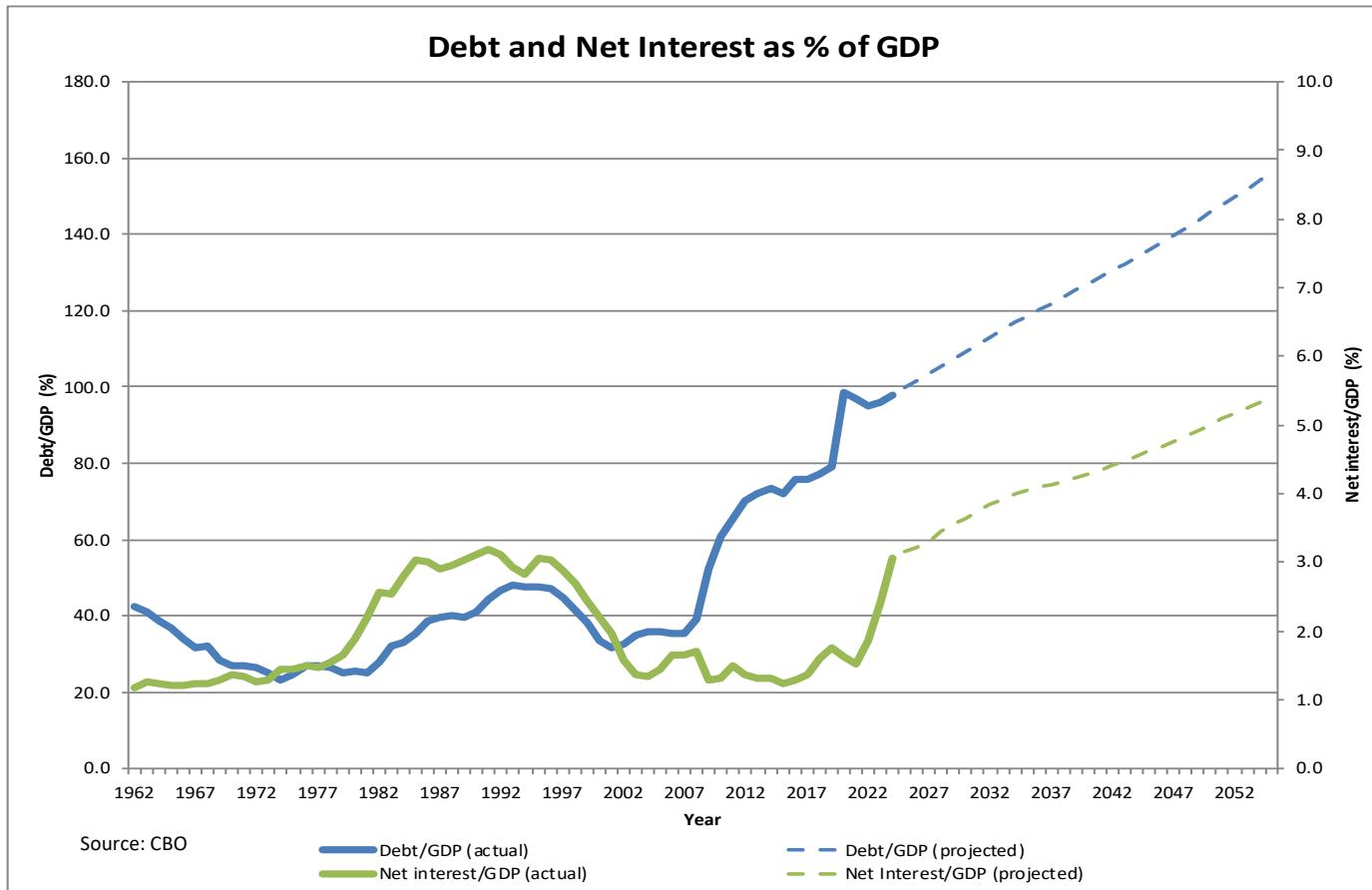
- Higher and more volatile inflation.
- Politically driven business cycles.
- Unanchored inflation expectations.
- More costly to stabilize inflation.
- Less flexibility to respond to labor market weakness.
- Higher longer-term borrowing costs.
- Less room to act forcefully in a crisis.

Should we be concerned?

- Trump is demanding exceptionally low interest rates to lower debt service costs.
- Trump has threatened Fed independence by attempting to dismiss a Fed Governor for alleged cause.
- Trump has asserted the President's right to fire Senate confirmed members of independent agency boards for policy reasons.

The U.S. is not in a fiscal dominance regime today.

- Fed raised rates sharply in response to post-pandemic inflation even though that worsened fiscal arithmetic, causing Fed's income to turn negative.
- Fed's asset purchase decisions focused squarely on Fed's mandated goals and threats to financial stability.
- Fed decisions now designed to achieve inflation and employment goals
- Long-term inflation expectations are well anchored.



Strengthening Preconditions for Fiscal Dominance

- Debt is on a steep upward trajectory
- Net interest costs: 3.2% of GDP and on track to rise above 5.4% in coming decades.
- Overall deficit is 5.9% of GDP- highest outside of wars and recessions.
- Primary deficit is roughly 3% of GDP: must be roughly balanced to stabilize Debt/GDP.
- 3 major ratings agencies have downgraded U.S. debt.

Can AI solve the problem?

- AI may boost productivity growth.
 - A 0.5% increase in TFP growth for 10 years would be helpful but not transformative.
- Need a 0.5% boost for 30 years to stabilize Debt/GDP.
- Faster productivity growth likely to raise r^* .
- Needed boost exceeds almost all estimates of AI's impact.

Negative shocks could trigger an unstable debt spiral

- With 100% Debt/GDP ratio a 1 percentage point increase in the average nominal interest rate on Treasury debt raises net interest roughly 1% of GDP.
- Could be due to higher risk premium on U.S. debt.
- Outcomes are worse if higher debt crowds out GDP growth.
- Slower immigration worsens fiscal outlook.

Institutional and Legal Protections

- Clear statutory mandate with operational independence.
 - Audit the Fed?
- 14-year staggered terms: removal only “for cause.”
 - But what constitutes “for cause”?
- Likely that Supreme Court will overturn Humphrey’s Executor but deem Federal Reserve “special.”
 - But can President remove Governors for policy differences pertaining to supervisory and other Board roles?
- Fed has budgetary autonomy.
 - Do income losses threaten this?

Avoiding Fiscal Dominance

- Requires credible, medium-term fiscal adjustment.
- Bipartisan deals are hard to achieve.
- Bipartisan cooperation may require market or political pressure:
 - Projected depletion of Social Security and Medicare HI Trust Funds in 2032.
 - Had meaningful deficit reduction in 2023 to avoid debt-ceiling standoff.
- Expect to avoid fiscal dominance but dangers are real.