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What can adversely affect the credibility of a central bank?

We examine the credibility of the central bank, which is defined as the confidence of private sector economic agents in its ability and willingness to prevent a lasting rise in inflation. Several configurations may lead to a decline in central bank credibility:

- the perception that it will comply with the demands of the political authorities, which generally favour low interest rates in order to support activity;
- the absence of a response to an inflationary shock, when that shock is likely to trigger an acceleration in wages and a rise in core inflation;
- a growing weight of short-term financing of the general government deficit, which amplifies the effect of a rise in short-term interest rates on the interest burden of general government debt.

An examination of long-term expected inflation in financial markets currently points to a loss of credibility, albeit a slight one, on the part of the Federal Reserve, the ECB and the Bank of England, and to a more marked loss in the case of the Bank of Japan.

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What is central bank credibility?

The credibility of a central bank is the extent to which private sector economic agents (firms, households) have **confidence in its ability to keep inflation close to its target over the medium term**. In the event of an inflationary shock, a credible central bank implements a restrictive monetary policy that brings inflation back towards its target over the medium term. **Medium-term inflation expectations therefore do not react to a short-term inflationary shock if the central bank is credible**. If the central bank is not credible, inflation expectations rise in the event of an inflationary shock, as do long-term nominal interest rates, with an adverse effect on output.

What developments can lead to a decline in central bank credibility?

1. The central bank's lack of independence from the political authorities

If the central bank is deemed by financial market participants to be **dependent on the political authorities**, markets will expect it to lower its policy rates in order to meet those expectations, since governments generally want lower rates to support activity and reduce the interest burden of general government debt.

This question arises today in the United States, with the appointment of Kevin Warsh as Chair of the Federal Reserve. Some observers fear that he will lower policy rates in order to satisfy Donald Trump's demands. This is not, however, the majority expectation in financial markets, since **short-term interest rate expectations remain high** (**Chart 1**), owing to the high level of inflation (**Chart 2**).

Chart 1
United States: Three-month SOFR futures (implied rate)

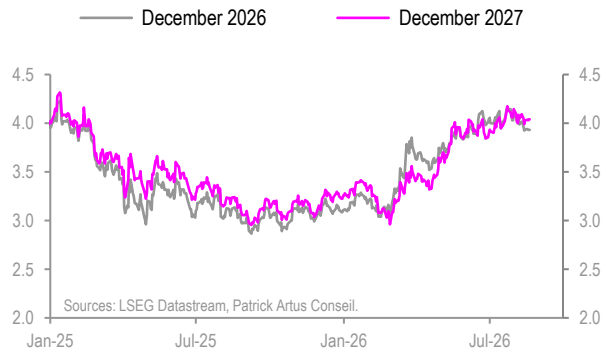
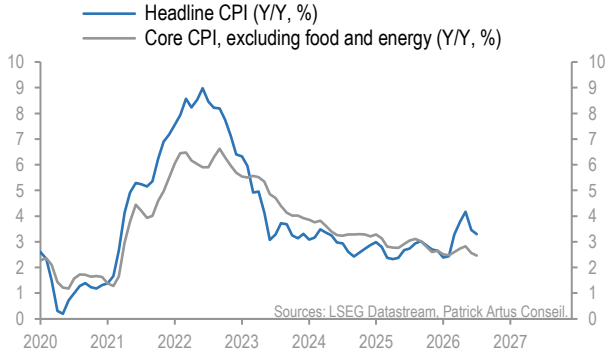


Chart 2
United States: Headline and core inflation



2. The central bank's failure to respond to an inflationary shock, when that shock is highly likely to lead to an acceleration in core inflation

If the central bank chooses not to respond to an inflationary shock, when that shock is likely to give rise to "**second-round effects**" (an acceleration in wages and a consequent rise in core inflation), its credibility will be undermined.

This configuration clearly materialised in the euro zone and in Japan after the outbreak of the war in Ukraine. Both central banks (the European Central Bank and the Bank of Japan) were significantly slow to respond to inflation, on the grounds that it stemmed solely from the rise in energy prices, whereas the inflationary shock was to trigger an acceleration in wages and a rise in core inflation in the euro zone (**Charts 3A** and **3B**) and in Japan (**Charts 4A** and **4B**).

Chart 3A
Euro zone: ECB deposit facility rate and inflation

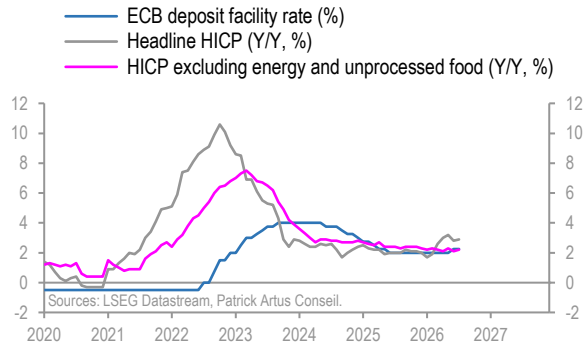


Chart 3B
Euro zone: Nominal compensation per employee (Y/Y, %)

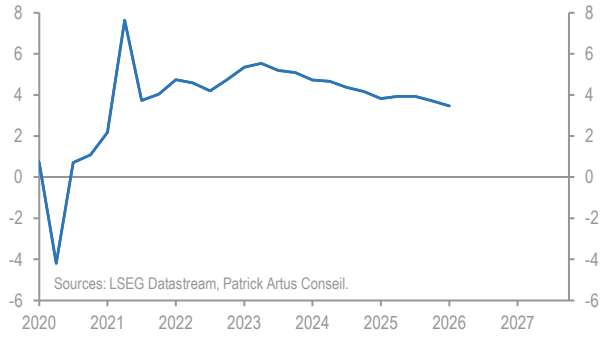


Chart 4A
Japan: Bank of Japan policy rate and inflation

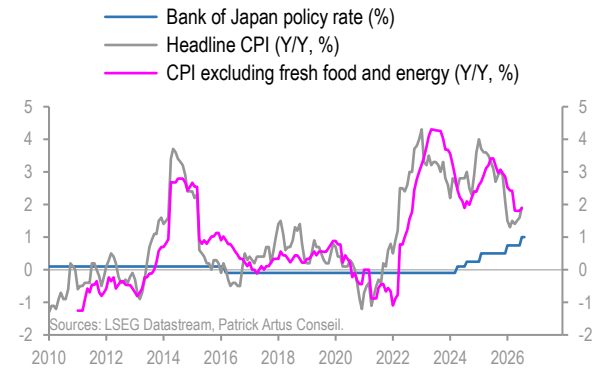
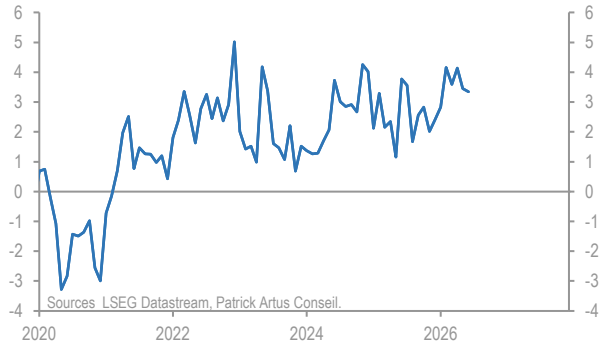


Chart 4B
Japan: Total cash earnings per employee* (Y/Y, %)



*Total cash earnings: wages, bonuses and overtime pay, excluding benefits in kind.

3. A growing weight of short-term financing of the general government deficit

If the general government deficit is financed to a significant extent by the issuance of short-term Treasury bills, the average maturity of the debt is low. If the central bank then raises its policy rates, the interest burden of general government debt rises rapidly. This configuration may lead **the central bank to forgo a rise in its policy rates**, even though the inflation risk would warrant one. The central bank's credibility is thereby weakened. The case of the United States provides an illustration.

In July 2026, the composition of US Treasury debt was as follows:

- 22.2% in bills (with initial maturities ranging from one month to one year);
- 51.4% in notes (with initial maturities ranging from two to ten years);
- 17.4% in bonds (with initial maturities of twenty or thirty years);
- 9% in other securities (TIPS, inflation-indexed securities, with maturities of five, ten or thirty years).

The average maturity of US federal debt is currently 5.4 years, markedly lower than in other large countries, such as France (8.2 years), the United Kingdom (13.4 years), Germany (8.3 years) or Japan (9.4 years). This debt structure exposes the United States to a highly unfavourable situation should the Federal Reserve need to raise its policy rates, hence a risk of loss of credibility.

Summary: has there been a decline in central bank credibility in the recent period?

As indicated above, a decline in central bank credibility could stem from:

- a risk of loss of independence from the political authorities;
- a failure to respond to an inflationary shock;
- a significant weight of short-term financing of the general government deficit.

We look at **ten-year inflation swaps** to measure central bank credibility in the United States, the United Kingdom and the euro zone, and at **ten-year break-even inflation** for Japan. All four central banks (Federal Reserve, Bank of England, European Central Bank, Bank of Japan) have a medium-term inflation target of 2%. **Charts 5A** and **5B** show:

- that the ten-year inflation swap rate moved above 2% in the euro zone in 2026;
- that it has been continuously above 2% in the United States since 2021;
- that it has remained above 2% in the United Kingdom since 2020;
- that ten-year break-even inflation in Japan rose from 1.18% in early 2024 to 1.77% in early 2026 and to 2.05% on 20 August 2026.

Chart 5A
10-year inflation swap rates (%)

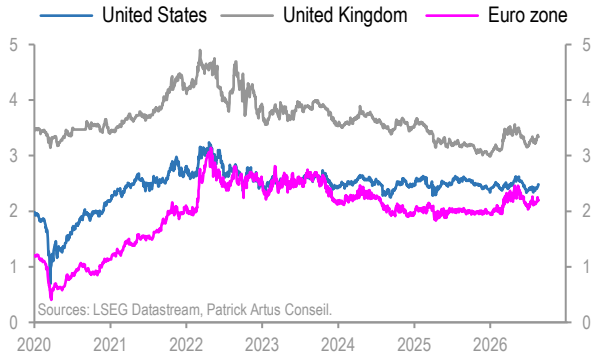


Chart 5B
Japan: 10-year break-even inflation rate (%)



It therefore appears that, if expected inflation above 2% signals a loss of central bank credibility, the Federal Reserve and the Bank of England are not credible, and that the credibility of the Bank of Japan and of the ECB has been deteriorating since 2021, markedly so in the case of the Bank of Japan.

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