Everything You Want to Know About the Future *of* Central Banking

But were afraid to ask.

By Biagio Bossone

For most of modern economic history, central banking has rested on a reassuring premise: that monetary outcomes, while imperfectly predictable, were ultimately steerable. Interest rates could be adjusted, and liquidity supplied or withdrawn, thus guiding expectations. For sure, inflation might deviate from target, growth might falter, and crises could erupt, but the institution at the center retained a decisive lever. Control, if not absolute, was nevertheless real.

This belief was never naïve. It rested on experience. Over long stretches of the postwar period, and especially during the post-disinflation era, central banks demonstrated a credible capacity to influence inflation, stabilize financial conditions, and anchor expectations. The mechanisms were imperfect and sometimes crude, but they were sufficiently reliable to sustain confidence in the institution.

That premise is now quietly breaking down. Across advanced and emerging economies alike, central banks are discovering an uncomfortable gap between action and outcome. Policy rates move sharply, yet inflation proves stubborn—or collapses unexpectedly. Balance sheets expand massively, yet credit transmission weakens. Communication is refined to near perfection, yet markets reinterpret

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
www.international-economy.com
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signals within minutes, sometimes seconds, often in unintended ways. Central banks act forcefully and coherently—and still find themselves chasing developments rather than shaping them.

This gap is not confined to moments of crisis. It appears in routine policy cycles, in periods of apparent calm, and even when institutions act pre-emptively rather than reactively. The problem is not timidity, nor delay, nor lack of resolve.

Today, uncertainty is an intrinsic feature of the environment, not a residual to be engineered away.

This is not a story of policy error or institutional failure. Central banks today are more transparent, more technically capable, and more analytically sophisticated than at any point in their history. Their models are richer, their data more granular, their toolkits broader. The problem lies elsewhere. The environment in which monetary policy operates has changed more profoundly than the frameworks designed to govern it. What has eroded is not competence, but command.

A STRUCTURAL SHIFT, NOT A CYCLICAL ONE

The loss of control is often discussed as if it were cyclical: a temporary distortion caused by pandemic shocks, supply bottlenecks, geopolitical fragmentation, or fiscal dominance. These explanations are not wrong, but they are insufficient. They describe stressors, not the deeper transformation underneath. The more unsettling reality is that the traditional transmission paradigm has been structurally weakened.

For much of the post-disinflation era, central banks operated in financially open economies yet retained a credible grip on outcomes. Capital mobility was high, global markets mattered, and external constraints were real. Yet policy transmission remained intelligible. Expectations adjusted with friction rather than instantaneously. Deviations occurred, but the system tended to re-center on the central bank's reaction function. Monetary control rested on an institutional equilibrium that, while never mechanical, was sufficiently stable to sustain credibility.

That equilibrium has eroded. The decisive change is not that global portfolio allocation now influences monetary outcomes in a way that defines financial conditions rather than merely conditioning them. Asset prices, long-term yields, exchange rates, and risk premia are repriced continuously through cross-border portfolios operating at a scale and speed that compress adjustment lags and weaken the hierarchy of influence. Monetary policy is absorbed by markets, reinterpreted, and arbitraged almost instantaneously. Lags that earlier allowed policy to work through domestic channels have now shortened or vanished. Expectations that once converged on central bank signals are today filtered through competing narratives—fiscal sustainability, political constraints, financial fragility, and global risk sentiment—before policy has time to take effect.

The shift did not occur overnight. Global portfolio forces have long mattered for monetary policy. What changed, gradually but decisively in the decade following the global financial crisis, was the institutional environment in which those forces operate. As balance-sheet policies became persistent rather than exceptional, forward guidance moved from complement to centerpiece, and markets increasingly priced policy feasibility rather than policy intent, portfolio dynamics moved from constraining transmission at the margin to defining it. The post-pandemic period merely revealed a transformation already under way.

As a result, even large and credible central banks increasingly operate in environments where marginal price-setting power lies outside their jurisdiction. Long-term interest rates move in parallel across economies with divergent inflation dynamics and policy signals—not because policy choices have converged, but because

The Erosion of Command

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Operating Under a New Dynamic

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As a result, even large and credible central banks increasingly operate in environments where marginal price-setting power lies outside their jurisdiction. Long-term interest rates move in parallel across economies with divergent inflation dynamics and policy signals—not because policy choices have converged, but because global portfolios have. Domestic policy rates still matter, but they no longer serve as anchors in the way they once did.

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These dynamics were first visible in small open economies, where aggressive tightening often failed to stabilize currencies or inflation expectations when global risk sentiment turned adverse. What is new is that similar patterns now increasingly characterize the core. Nor does the recent turn toward geopolitical fragmentation restore control. Financial portfolios remain global, liquid, and reflexive even as trade and production patterns adjust, narrowing policy margins and heightening sensitivity to confidence shocks. In this world, central banks still set instruments. But they no longer determine outcomes alone.

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THE GAP BETWEEN AUTHORITY AND EFFECTIVENESS

This structural shift has produced a growing, if often unspoken, unease within the profession. Mandates remain expansive. Balance sheets are large. Legal authority is intact. And yet, the mapping from decision to result feels increasingly tenuous.

The unease is visible in several symptoms. First, there is growing reliance on ever-stronger actions to achieve diminishing marginal effects. Rate moves are larger and more abrupt than in the past. Communication is more frequent, more explicit, and more conditional. Balance sheets are deployed not merely as crisis tools, but as standing instruments of policy. Yet the sense of precision has not improved. Policy moves generate responses—but not reliably the intended ones.

Second, explaining outcomes *ex post* is increasingly difficult. Persistent inflation overshoots or undershoots are attributed to an expanding list of factors—global shocks, nonlinearities, financial frictions, expectation errors—without restoring confidence that future adjustments will be more effective. Explanation begins to substitute for control, and narrative, increasingly, for mechanism.

Third, and most consequentially, there is the rising tension between independence and accountability. Independence was justified by effectiveness: central banks were insulated from politics because they could reliably deliver outcomes. When outcomes become uncertain and jointly produced with markets, that justification weakens. Central banks are held responsible for results they only partially control, while political actors question mandates that no longer appear to deliver.

This creates a dangerous asymmetry. Authority remains centralized; effectiveness is increasingly distributed. Responsibility without control becomes politically fragile. Over time, this risks not only policy effectiveness, but institutional legitimacy itself.

None of this implies that central banks should retreat into passivity or abandon their mandates.

These tensions are not accidental. They reflect a mismatch between a control-based conception of monetary policy and a reality in which policy operates through influence, credibility, and coordination rather than command.

WHY THE OLD PARADIGM NO LONGER FITS

At the heart of the problem lies an assumption that long went unquestioned: that monetary policy operates in a stable structural environment, where relationships between instruments, expectations, and outcomes are sufficiently invariant to be exploited.

That assumption no longer holds. Structural parameters—such as the sensitivity of inflation to slack, the responsiveness of investment to interest rates, or the anchoring of expectations—are themselves contingent on beliefs about policy credibility, fiscal backing, and institutional coherence. When those beliefs shift, the parameters move with them. Transmission is no longer noisy-but-stable; it is state-dependent and belief-contingent.

This marks a fundamental departure from the traditional paradigm. Previously, monetary policy worked by adjusting instruments within a known, if imperfect, mechanism. Markets reacted; expectations followed; outcomes adjusted with lag. Today, expectations move first, markets reprice continuously, and policy operates within a belief-mediated environment it does not fully control.

This is why similar policy actions can produce radically different outcomes across countries—or across time within the same country. It is why tightening can sometimes fuel inflation expectations rather than contain them, and why easing can fail to stimulate demand even when financial conditions appear accommodative.

The implication is profound: monetary policy is no longer a problem of fine-tuning a known mechanism, but of operating within a system characterized by endogenous feedbacks, nonlinear responses, and shifting reference points.

In such a system, the illusion of control is particularly dangerous. It encourages overconfidence, delayed adaptation, and excessive reliance on tools whose effectiveness depends on institutional conditions that no longer reliably hold.

NOT INFLATION OR DEFLATION, BUT IRRELEVANCE

The greatest risk facing central banking today is not another inflation surge, nor a return to deflation. It is something more subtle and more corrosive: policy irrelevance.

Irrelevance does not mean that central banks stop acting. It means that their actions cease to function as focal points for expectation formation. Markets move first; policy follows. Expectations form elsewhere; central banks react. Balance sheets expand, but credibility constraints bind.

In such a world, crises become harder to manage—not because central banks lack tools, but because those tools no longer coordinate beliefs effectively. Each intervention risks being interpreted as confirmation of weakness rather than strength, accelerating rather than dampening instability. This is the tunnel in which the profession now finds itself, whether it admits it or not. It is uncomfortable and unfamiliar, but it is not endless.

Central banking has rested on a reassuring premise: that monetary outcomes, while imperfectly predictable, were ultimately steerable. That premise is now quietly breaking down.

The way forward does not lie in reclaiming a lost control that no longer exists. It lies in redefining what effective central banking means under radically changed conditions. Monetary policy today is best understood as a credibility-constrained, market-mediated

The New Way Monetary Policy Works

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process rather than a mechanical transmission exercise. Its effectiveness depends less on the precision of instruments than on the coherence of the institutional environment in which those instruments operate.

This has concrete implications for practice. Credibility must be treated as a policy variable, not a background asset. It is shaped continuously by consistency across monetary, fiscal, regulatory, and financial-stability policies. Fragmentation across domains weakens transmission more than any single policy mistake.

Central banks must also move from signaling paths to shaping states. Forward guidance that promises specific trajectories is increasingly fragile in a world of rapid repricing. What matters more is clarity about reaction functions, constraints, and priorities under uncertainty.

Resilience should replace precision as the guiding objective. In a belief-sensitive system, avoiding catastrophic loss of confidence is more important than hitting point targets. This favors robustness, optionality, and institutional coordination over fine calibration.

Finally, central banks must acknowledge openly that markets are not merely transmission channels, but co-producers of outcomes. Policy effectiveness depends on how markets internalize, amplify, or counteract policy signals. Engaging with this reality is not a concession—it is a source of strength.

For Central Banks, A Redefining Moment

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REINVENTION, NOT RETREAT

Seen in this light, the fading of the illusion of control is a moment of institutional maturation. What is being tested is not whether central banks can adapt their self-understanding to an environment in which force alone no longer guarantees traction.

This requires a more candid appraisal of how monetary authority is exercised in practice. Central banks do not operate above markets; they operate within them. Their actions are interpreted, priced, arbitraged, and sometimes contested by actors whose balance sheets rival or exceed those of the public sector. In such a setting, authority is diminished by pretending those limits do not exist.

The traditional transmission paradigm has been structurally weakened.

Markets no longer respond primarily to discrete announcements; they respond to perceived regimes. They infer durability, coherence, and political backing—or the lack thereof—from patterns rather than pronouncements. A policy stance that is technically sound but institutionally isolated will struggle to anchor expectations. Conversely, a policy framework that is internally coherent and credibly supported across the state

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apparatus can retain influence even when outcomes deviate temporarily from targets.

This also reshapes the role of uncertainty. For much of modern central banking, uncertainty was treated as an obstacle to be minimized through better models, clearer communication, and more refined forecasting. Today, uncertainty is an intrinsic feature of the environment, not a residual to be engineered away. Attempting to eliminate it through excessive signaling risks backfiring, as each conditional statement becomes another variable for markets to stress-test and arbitrage. Strategic restraint—knowing when not to specify paths, thresholds, or timelines—can enhance rather than undermine credibility.

At the same time, the distributional and political consequences of monetary policy can no longer be treated as peripheral. When financial markets are the primary arena of transmission, policy inevitably reallocates wealth, risk, and opportunity across sectors and cohorts. Ignoring these effects does not preserve technocratic neutrality; it erodes it. Legitimacy in a world of diffuse effectiveness depends on demonstrating awareness of trade-offs, not on denying their existence.

None of this implies that central banks should retreat into passivity or abandon their mandates. On the contrary, it suggests a more demanding standard of performance. Acting under conditions of partial control requires sharper judgment. It requires distinguishing between what can be stabilized and what must be absorbed, between disturbances that threaten systemic confidence and fluctuations that do not. It also requires resisting the temptation to compensate for reduced effectiveness by doing more of the same—larger moves, louder signals, broader interventions—when the underlying constraint is structural rather than cyclical.

The profession's challenge, then, is not to restore a lost world in which instruments reliably delivered outcomes, but to articulate a credible role for monetary policy in a world where outcomes are jointly produced. That role is necessarily more modest in its claims, but not in its importance. By shaping the institutional perimeter, clarifying constraints, and coordinating expectations across policy domains, central banks can still act as anchors, even if they no longer serve as engineers.

This reframing also offers a way out of the growing tension between independence and accountability. Independence was never an end in itself; it was a means to ensure that policy could be conducted with a long horizon and a systemic perspective. Preserving it now requires redefining success away from mechanical target attainment and toward sustained macro-financial coherence. Accountability, in turn, must be grounded in transparent reasoning and institutional consistency, not in the pretense of control over outcomes that no single actor can deliver.

Central banking has reinvented itself before—when gold convertibility collapsed, when Bretton Woods ended, when inflation targeting replaced discretion, when balance sheets became permanent. Each rupture forced a rethinking of purpose and tools. Each time, the institution emerged more realistic, not weaker.

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The current transition is no different. It demands intellectual honesty, institutional humility, and conceptual innovation. The central bank of the future will be less obsessed with levers and more focused on coherence; less committed to mechanical rules and more attentive to belief dynamics; less confident in control and more skilled in influence.

Such a central bank does not promise to determine outcomes. It promises to help hold the system together when outcomes are shaped by forces no single authority commands. In a world where control can no longer be taken for granted, that promise may be the most credible—and, in the end, even the most valuable—form of monetary authority that is left. ◆