The Craft of Monetary Policy: From the Blackboard to the Trenches[1]

Phurichai Rungcharoenkitkul

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Introduction

Thank you to the organisers for the incredible privilege of speaking at the WEAI conference dinner. The WEAI has a distinguished history stretching back nearly a century, and it is truly humbling to be asked to hold your attention today. I am aware that talking about monetary policy over dinner at this late hour is a bold move—it's the kind of endeavour that a policymaker might flag as a significant risk to the outlook. But I hope the payoff will be worth it.

As the title suggests, tonight I want to draw on my experience of moving between the blackboard and the trenches. I spent almost half of my career at the Bank of Thailand, most recently as Director of Monetary Policy—a role I liken to fighting in the trenches. It was intellectually demanding, but also fast-paced, chaotic, and constantly springing challenges that PhD training does not prepare you for. The other half of my career, at the BIS, has been equally demanding intellectually but more tranquil and academic—better suited for thinking deeply about monetary policy and attempting to see through the fog of war.

Combining perspectives from theory and practice—from the blackboard and the trenches—I will make three observations about the relationship between central banks and governments.

First, this relationship has grown more fraught in recent years, as political pressures on central banks have intensified around the world. And it could strain further, as we grapple with geopolitical tensions and the uneven impact of artificial intelligence.

Second, central banks can do more than you might think to meet these challenges. But it will not be easy. It will take a great deal of fortitude to resist the pressures. The

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Navy Seals have a motto “Never out of the fight” -- central banks may need a similarly hardened attitude in pursuing their mandate.

Finally, to defend their independence, central banks should be their own fiercest critics. That means placing their intellectual ideas and analytical tools under constant scrutiny. I will give some concrete examples drawing on my own work—on the natural rate of interest. But, more generally, I am advocating a broad and flexible intellectual lens, which ultimately serves to underpin the credibility, legitimacy and independence of the central banks.

The threat is real, and the safeguards are weaker than we think

The interactions between fiscal and monetary authorities are of course an age-old topic. We all know that bad things happen when monetary policy bows to fiscal demands and history is filled with cautionary tales. Painful lessons of the past are why countries grant their central banks operational autonomy to formulate monetary policy today.

Unfortunately, despite this hard-won wisdom, political pressures and encroachment on central bank independence seem to have resurfaced. To be sure, central bank independence has never been absolute and political pressures have always existed. But the intensity, and increasingly public nature, of recent political pressures are certainly noteworthy and deeply concerning.

What could explain this? One possible reason is that unevenly distributed growth has fuelled populism. When things are not going well, it is politically convenient to find a scapegoat. Another possible reason is the deteriorating fiscal position across the globe. As the fiscal space shrinks, the temptation to seek monetary escape valves grows.

If this diagnosis is correct, political pressure on central banks could be a trend rather than a blip. AI advances and labour replacement could further exacerbate inequality and strengthen populism. Geopolitical tensions alongside an aging population could add to fiscal burdens, as public debt continues to reach new record highs.

Some may think that we have solved this institutional tension by granting central banks operational autonomy through legislation. Today, the vast majority of central banks enjoy some form of statutory independence. Four in five have sole authority to formulate monetary policy; only a third did in 1990. In over 130 countries, laws have been reformed to strengthen central bank autonomy since 1990.

However, despite this great progress, legal protection is not bulletproof. It works more like a soft body armour—it weakens the political punch but does not completely block it. Of course, central banks are public institutions and should be answerable to the public, so their legal protection must have limits. But this leaves room for interference under the guise of checks and balances. Political pressures can also be tacit and indirect, evading the reach of the law. Thomas Drechsel has a fascinating paper[2] documenting President Nixon's pressure on the Fed Chair Arthur Burns through private conversations, which only came to light via tape records and diary. The law lacks teeth against these non-public interferences, and we have little idea how common they are. But I suspect they would have made for a long and entertaining drama series!

Remember, too, that the appointment of monetary policy committee members is often a deeply political process. Operational independence means little if the government can appoint a compliant policymaker—or, more subtly, an independent technocrat who happens to share the government's views and preferences. Central bank independence does not just mean insulation from outside pressures. It also requires policymakers to stay true to the intent of their mandate. And that is not guaranteed to be the case at all times.

Financial markets—the so-called bond vigilantes—are supposed to be another safeguard. An attack on central bank independence could instigate macroeconomic instability, leading to higher risk premium. This threat could act as a deterrence.

But how "vigilantic" have investors been? At least for those economies with a track record of stable prices and independent central banks, the bite has been rather weak. Consider the United States, where there were 29 instances of public pressure on the Fed chair between April 2025 and January 2026. On those days, the average absolute move in 10-year bond yields was 4 bps, no different from the typical daily movement. By these metrics, supposed bond vigilantes not only have little bite, but they also hardly bark.

Why is that? One explanation is that financial markets learn from history to discard threats to central bank independence. When regime changes are rare, markets may trust that the central bank can weather political pressures that come and go. But if true, this has a troubling implication. A central bank can become a victim of its own success: a strong track record of independence means markets don't rush to the

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[2] Drechsel, T (2025) "Political pressure on the Fed", forthcoming in *Review of Economic Studies*.

rescue when that independence is under threat. The safeguard is weakest when the central bank has the most to lose.

The perception of a weak safeguard alone can create problems. When a central bank is under attack, is a cut in interest rates justified by macroeconomic conditions or a capitulation to political pressure? The public may not be able to tell the difference. This puts even a non-compliant central bank in a tough spot, as it may have to factor in credibility along with other policy trade-offs.

The best defence is not to retreat, but to persevere

So if the safeguards are weaker than we thought, what should the central bank do about it?

Let me distinguish two types of attack on central bank independence. The first is a head-on attack on the institutional framework—attempts to weaken the central bank's legal protection, exert coercion, or replace policymakers by compliant ones. The second is softer but no less dangerous: an attack on the central bank's intellectual credibility. This involves attempts by the government or its surrogates to undermine trust in the central bank, sour public opinion, and ultimately pressure for policy change. Corroding credibility may also serve as a prelude to a head-on attack down the road.

What makes this second type of attack particularly corrosive is that it undermines both the central bank independence and constructive policy debate. Dialogue about monetary policy is a normal and healthy process in any society. The central bank benefits from such feedback and derives from it the legitimacy it needs to operate. But precisely because it can be hard to tell apart well-meaning criticism from disingenuous ones, it is easy for a bad-faith actor to disguise their true intentions.

Against a head-on institutional attack, the central bank has limited options on its own. This is when the credibility and public trust earned in the past must prove its mettle. The rest of us can also help defend central bank independence, even when we disagree with its policies. This is not a contradiction—it is the foundation of the entire institutional design. I trust I don't need to labour this point with this audience.

Faced with a soft attack, communication can be one well-honed tool to use. The central bank can appeal to the mandate, highlight that independence is about operations rather than objectives, and calibrate who says what, when and how. But what happens when words are not enough? The central bank could of course simply yield – but that is a slippery slope. The more interesting question is, if the central bank does not wish to yield, what kind of policy strategy would be most desirable.

Consider two starkly different options. One is the “minimalist” strategy: the central bank interprets the mandate narrowly and sets aside broader policy considerations that may be relevant but are harder to explain. And it anchors decisions tightly to a key target, typically inflation, and relies on a simple reaction function to guide and communicate policy. The appeal is straightforward: it limits the surface area for political attack. A central bank that *appears* to do exactly the job it was founded to do and can explain its decisions plainly is harder to criticise.

The alternative is to persevere with a “holistic” approach: interpreting the mandate according to its intent rather than its letter. This means assessing the outlook through the full lens of demand pressures, supply shocks, inflation expectations, policy lags and so on. With a broader mandate, the central bank would also internalise more medium-term tradeoffs to ensure macroeconomic stability, possibly taking into account financial imbalances as well. This is harder to communicate, more exposed to criticism, and demands more of the audience. When credibility is already in question, the complexity may invite more scrutiny, not less.

The minimalist road, at face value, may seem like a prudent tactical retreat. But I believe it carries serious hidden costs.

Most obviously, an overly simplistic and rigid reaction function risks producing sub-optimal policy, especially when facing a complex confluence of shocks—which, let’s be honest, is most of the time these days. And while it may relieve short-term political pressure, a narrow approach could undermine credibility as the medium-term economic consequences of blunt policymaking become visible. Short-term gains may come at the cost of long-term pain.

There is a deeper cost too. As setting interest rates becomes a more mechanical exercise, the institutional capacity to think, to research, to stay “plugged in” to the evolving structure of the economy—that capacity atrophies. This cannot be easily replaced from outside. The unique combination of analytical rigour and front-row exposure to live policy challenges is rarely found outside central banks, where blackboard knowledge gets implemented in the trenches. Losing it would be a cost borne not just by the institutions, but by our entire field.

So my argument boils down to this: the best defence of central bank independence is not to narrow the policy focus and minimise the scope for criticism. It is to strengthen public trust through a deliberate and unrelenting pursuit of the mandate in substance, not just in form. After all, the credibility that central banks enjoy today has been earned through the courage to do the right thing even when it is unpopular. This means taking the harder road. The one that leads somewhere worth going.

Even our best intellectual tools need constant scrutiny

If we are to take the holistic approach seriously, we have to broaden our perspective not only about the tradeoffs, but also the lens through which we view them. This brings me to my final point: the craft of monetary policy cannot rest on a static state of knowledge. We must be willing to challenge conventional wisdom to continue making progress. Indeed, we gather at conferences like this precisely to do that.

In that spirit, let me offer one concrete example and re-examine one influential concept that I believe would benefit from more critical scrutiny. That is the natural rate of interest, or r-star.

Dating back to Wicksell in 1898, r-star may be defined as the real interest rate compatible with stable inflation and output at its potential. In practice, it serves as the benchmark for neutral monetary policy: the rate at which policy presses neither on the accelerator nor the brake. To stimulate the economy, the central bank pushes the real interest rate below r-star. To restrict demand, it pushes rates above r-star. If r-star is moving, the policy rate must also move in tandem, simply to keep the policy stance unchanged. From this perspective, knowing where r-star is seems essential for monetary policy.

But r-star is never directly observed. Inferring its value from data is a daunting task, involving identifying assumptions that are difficult to falsify empirically. It is not unusual for the confidence band to be several percentage points wide, which limits the practical use of the concept—like being handed a compass with a 180° error band.

Even so, powerful r-star narratives have shaped the global monetary policy debate. After the Great Financial Crisis, the predominant view was that r-star had fallen so dramatically that even zero percent nominal interest rates were seen as insufficiently accommodative. This conviction—supported by hypotheses such as slowing productivity, demographic headwinds, and a higher safe-asset premium—became a justification for the low-for-long interest rate of the post-crisis decade. It also gave impetus to unconventional policies that are still leaving their mark today, twenty years later, in the form of outsized central bank balance sheets.

Given this narrative's enormous influence on policymaking, you might be surprised how little empirical support it actually has. Together with BIS colleagues, we conducted a cross-country analysis for major advanced economies going back to the nineteenth century and found no systematic relationship between real interest rate trends and the usual suspects, such as productivity growth, demographics, inequality and other factors.[3] Several other studies using even longer data have similar findings.[4]

Another puzzle involves the "natural rate" hypothesis itself—the idea that r-star is determined solely by structural forces beyond the control of central banks. Yet, there is well-known evidence that long-term forward rates—which reflect, at least in part, market expectations of r-star—are highly sensitive to monetary policy. Whenever the central bank cuts its rate, financial markets conclude that r-star has fallen. Perhaps this is less surprising than it sounds. Ask people what they expect steady-state interest rates to be, and their answers depend heavily on the rate environment they know. In the 1990s you might hear 5%. In the 2010s, 1-2%, if that. Ask today, and it may be higher again.

This perspective suggests that the "neutral" interest rate may not be a function of deep fundamentals alone, but also of people's perceptions—perceptions that can be shaped by monetary policy itself. If true, the implications are striking.

Together with my co-author Fabian Winkler at the Federal Reserve Board, we show that a "hall-of-mirrors" phenomenon can emerge.[5] Imagine a sharp rate cut designed to jump-start the economy. If that cut leads people to revise down their perceived r-star, the distance between the policy rate and the effective r-star would compress, and the boost to the economy would be smaller than expected. Disappointed with the result, the central bank may cut rates again, but this only prompts further revisions to the perceived r-star, and so on. A ratcheting effect can push policy rate endogenously toward the effective lower bound, even when the structural fundamentals have not changed. Moreover, communication about r-star may be counterproductive: saying that one must ease because r-star has declined may move the goalpost and make policy less rather than more accommodative. It is rather like trying to catch your own shadow.

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[3] Borio, C, P Disyatat, M Juselius and P Rungcharoenkitkul (2022) "Why so low for so long? The long-term view of real interest rates", *International Journal of Central Banking*, 18(3), September.
[4] See, for example, Rogoff, K, B Rossi and P Schmelzing (2024) "Long-run trends in long-maturity real rates, 1311-2022", *American Economic Review*, 114(8), August.
[5] Rungcharoenkitkul, P and F Winkler (2026) "The natural rate of interest through a hall of mirrors" *Journal of Monetary Economics*, 157, January.

What lessons might this perspective hold for today? The last five years have been anything but boring. The post-pandemic inflation surge forced central banks to raise rates to their highest levels in 20 years. And, believe it or not, the r-star narrative began to shift. The old story of a chronically low natural rate gave way to a new one of higher-for-longer r-star. The very demographic forces previously used to justify a low for long rate are now reinterpreted as pushing up the natural interest rate. More recently, the AI revolution joins the list of usual suspects. I cannot help but notice the similarities with the post-GFC period, when very low policy rates *preceded* the narrative about low r-star. Could we be staring into the hall of mirrors all over again? If nothing else, how quickly the view has shifted about a supposedly slow-moving object like r-star should give us pause.

Finally—and here the circle closes—the r-star narrative may have implications for the fiscal-monetary interactions I touched on earlier. Fiscal sustainability is often assessed through the lens of r minus g, the difference between the real interest rate and the growth rate of the economy. When r minus g is lower, the government can run higher deficits without destabilising its debt. If you believe interest rates will stay low, you worry less about balancing the fiscal books.

But the hall-of-mirrors logic applies here too, and the consequences may be even more far-reaching. If a low-rate environment creates a false confidence in fiscal sustainability, it could encourage more expansionary fiscal policy, putting public debt on a higher path. The higher debt then comes back to haunt the central bank in the form of greater political pressure to keep interest rates low—producing another ratcheting effect. This fiscal variant of the hall-of-mirrors mechanism is not far-fetched. During the low-for-long years, CBO lowered the terminal yield assumption by 1.5 percentage points. This created an impression of greater fiscal space. Even if the authority follows a balanced-budget fiscal rule, the debt to GDP could go up by 15 percentage points after a decade, all because the authority underestimates r-star.

Conclusion

Let me draw the threads together. The growing political pressures on central banks are a concern for us all. We should do our part to defend the institution's autonomy. But the most consequential actions must come from the central banks themselves. Not by retreating into a corner and hoping the storm passes. But by earning and re-earning public trust through a relentless pursuit of the mandate, hard intellectual work, and continuous self-scrutiny.

This demands both humility and boldness. Humility, because our understanding of the economy is always incomplete. Boldness, because we must be prepared to challenge conventional thinking—including our own. It is not an easy road and there will be setbacks. But as the motto goes—never out of the fight. It would be a less lonely journey, though, with the support of people in this room—whether you are a seasoned researcher who has seen many policy cycles, or a young scholar just starting out, who may one day find yourself, as I did, transplanted from the blackboard to the trenches.

Thank you again for the privilege. I look forward to your questions. It's the kind of pressure on a central banker for which I will make an exception.