# Leadership and Management in Central Banking (Part 2)

In the November issue I outlined:

- The growing importance of internal leadership and management
- A model for the development of a central bank through "three ages"
    - Mainly operational functions, demanding administrative reliability
    - Policy functions, demanding diverse managerial and technical skills
    - “Influencing” roles, demanding creativity and a flexible resource base
- How the leadership and management practices that fit a central bank well in one age can undermine its progress into the next
- How autonomy can be used to wisely manage risk, or unwisely defer change
- The benefits from embracing leadership and management change

This article will first consider priorities for central banks in developing countries and look at indicators of efficiency and accountability for central banks in developed countries. It then summarises key practices for each age and outlines how a change program can be effectively planned and managed.

### Current Leadership and Management Issues

What age are most central banks in? All of them at once, to some extent. No model fits reality perfectly.

For some developing country central banks that are struggling with essential operations, the main priority is building a critical mass of basic capacity. "First age" management systems are necessary and appropriate.

But in many developing countries central banks have reached a stage where inappropriate leadership and management practices are constraining achievement. Symptoms include:

- Organisational structures that do not support current functions well
- Overload at the top through insufficient or ineffective delegation
- Difficulty in attracting and retaining talented people
- A struggle to get creative outputs from policy functions
- Proliferating "internal support" departments with growing resource levels
- Above-market remuneration paid to long-serving staff of limited future value
- A lack of cost information and difficulties in controlling costs

Planning and execution of a transition to the second age needs committed and strong internal leadership. Key risks include political interference and a shallow pool (internal and external) of management skills. But the potential returns are huge. An effective and efficient central bank can play a leadership role not only for the public sector but even for business practice. And because globalisation compresses timeframes for economic and organisational change, central banks in developing countries should make an early start on planning for the third age of central banking.

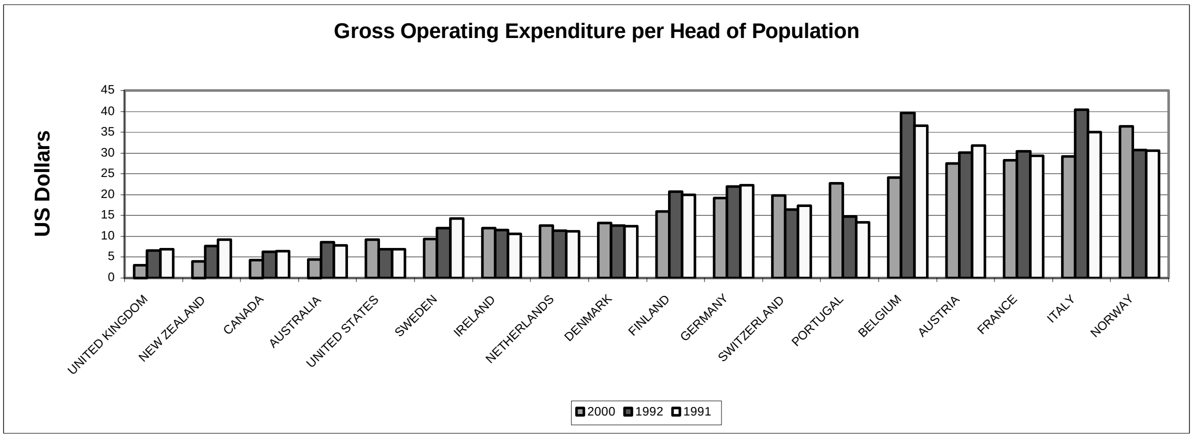
Nevertheless the very different management needs of operational functions cannot be neglected. A pragmatic approach may be to deliberately tune management practices around different operational and policy functions, accepting the consequent lack of uniformity across the organisation.

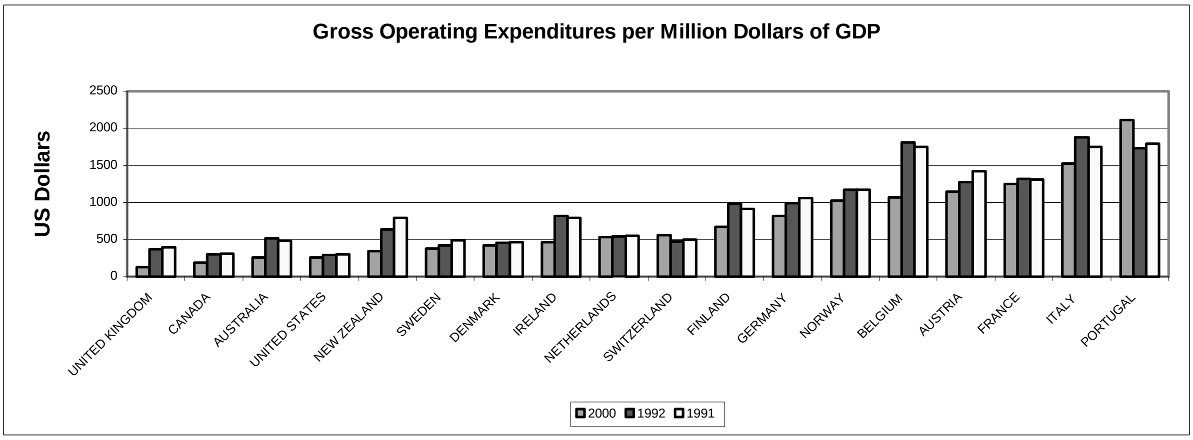
In developed countries, central banks have had time and resources to develop their policy functions and prepare for a future beyond that. We might presume that they have already met the challenges of effectiveness and efficiency and apply management practices that anticipate the third age. But the evidence suggests otherwise.

## Efficiency Comparisons

In 1993 I began a study of central bank operating efficiency in OECD countries, under IMF sponsorship and with the active cooperation of the central banks studied. Two indicative measures of efficiency were applied: operating costs per head of population and operating costs per dollar of GDP. [1]

The results, derived for each bank's 1991 and 1992 financial years, were startling. Indeed in some quarters they were clearly unwelcome, and publication did not occur despite positive peer reviews. To see if anything had changed, the methodology was recently applied to the 2000 financial year. The graphs below show the results, ordered according to costs reported for the 2000 financial year:




These comparisons suffer from many limitations, notably variations in the functions performed, measurement problems and inconsistent disclosure. Nevertheless the results demonstrate an industry crying out for change:

[1] The methodology was deliberately kept simple. It aimed only to establish an initial indicative benchmark.

- The gaps between the best performers and the worst ones are immense. Those gaps appear far greater than they could be if similarly good practices were being generally applied across the group.
- The differences cannot be explained by economies of scale. Some small countries and some large countries score well, while others score badly. Likewise for richer and poorer countries.
- Little convergence is occurring. Changes over nine years -- a long time in management -- show no particular pattern. Some central banks are improving their absolute or relative performance; others are not.
- Differences are not explained by cost recovery practices. Both gross operating costs and operating costs after such recoveries were considered. The results were much the same under both calculations.

Differences in the cost to GDP comparison – the “overhead” a central bank imposes on its national economy -- are particularly noteworthy.[2]

This seems a surprising outcome. What barriers to continuous improvement and industry convergence exist? Substantial political interference with internal management is rare. Few organisations target inefficiency, and central banks actively learn from each other. Any shortage of management skills should be easy to remedy through recruitment or engagement of external resources.

So what is missing?

## Reporting Comparisons

Many readers will be aware of the dramatic changes in efficiency achieved by the Reserve Bank of New Zealand (RBNZ) in the late 1980s. One conclusion from that reform was that business management is (with appropriate adaptation) directly applicable to central banking. Another was that effectiveness and efficiency, far from being in conflict, tend to be mutually reinforcing. But perhaps the key conclusion was why the speed and scale of that change was so unique: "Motivation (to change) was probably a powerful influence on the scope and speed of transformation at the RBNZ. Other than motivation, no major special factors appear to have operated." [3]

The difficulties in reforming monopoly entities from within are well known. An insular organisation that applies outdated management and career frameworks will by definition tend to retain opponents of change and discourage or drive away change agents. So weak intrinsic motivation is likely to be holding back change at many central banks.

Pressure for change need not come from within. Even commercially, organisational change usually comes as a response to external pressure rather than internal enthusiasm. But external pressure on central banks has so far been uniquely weak:

- Central banking is not well understood by the public or their representatives.
- The revenue from a central bank's seigneorage monopoly usually far exceeds its operating expenses, so this "state-owned enterprise" looks profitable.
- Central bank operating expenses are a tiny part of total government expenditure.

[2] This ratio is not materially influenced by exchange rates, since both sides of it are converted at the same rate.
[3] IMF Working Paper WP/94/37 "Improving the Management of a Central Bank -- A Case Study".

- Many central banks minimise their external reporting and disclosure.

The latter statement may sound bold, perhaps even offensive. But evidence can be cited. The study that examined efficiency also assessed external reporting and accountability. It reviewed the annual report of each central bank, asking simple questions that a hypothetical taxpayer knowing little about central banking might reasonably ask:

1) Is the report and the information in it presented clearly?

2) Does the report try to communicate with this hypothetical reader?

3) Does the report explain what the central bank does?

4) Does the report explain what the central bank did last year?

5) Does the report explain how the central bank is managed?

6) Does the report provide adequate accounting information?

7) Does the report disclose the cost of the central bank's various activities?

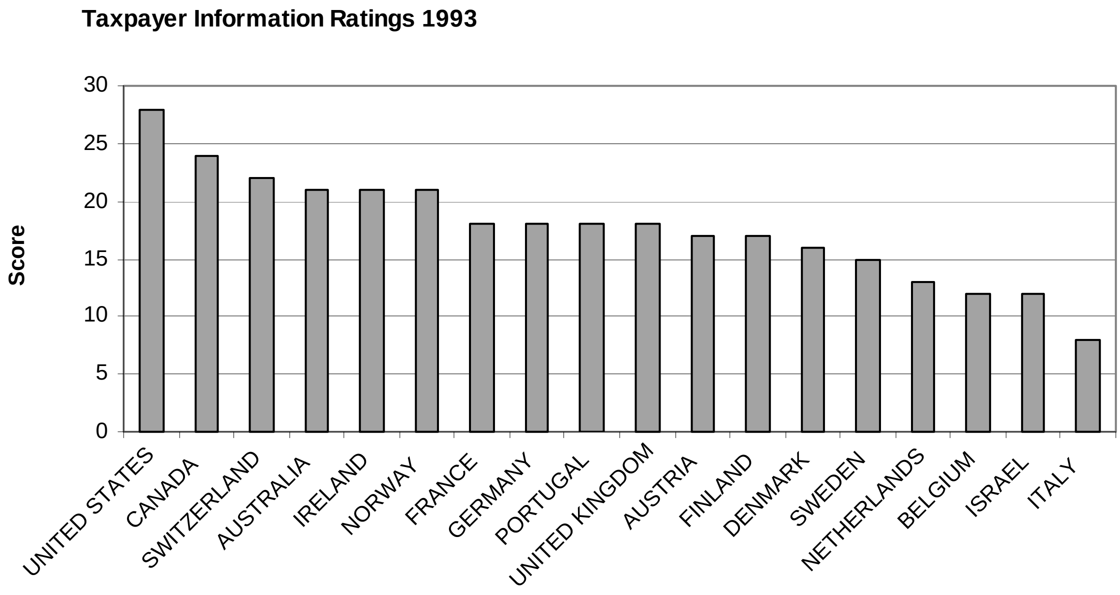
8) Does the report provide information about the central bank's plans for the coming year?

9) Does the report provide information about what the central bank plans to spend on its operations next year?

10) How committed to accountability does the central bank seem to be?

Each report was first scored on a 0-3 scale for each question; then scores were totaled to produce "taxpayer information ratings".[4] Scoring was generous, aiming to pick up differences even where the average result was weak.

[4] Because the questions were influenced by RBNZ's external reporting objectives, New Zealand was omitted from the analysis.




Once again, the comparisons suffer from some limitations. However the outcome is clear. The questions asked are certainly fair and reasonable. And scoring set a low and achievable hurdle – certainly some central banks scored well. But many scored poorly, and over the group as a whole external accountability was not impressive.

The weakest results were in questions 7 to 9 — costing, planning and budgeting. Weakness here was not only in disclosure. Indications also emerged that much of the service performance and cost information that a hypothetical taxpayer might want was not even available internally. Did those central banks undertake any objective and systematic analysis of their service performance and cost?

This assessment of external reporting and accountability has not been formally updated. However a quick glance at reports from the same central banks suggests little has changed. Anecdotal evidence about management practices also suggests that many central banks are not yet "hearing the message" about greater efficiency and accountability.

This insulation from reality is ultimately unsustainable. Sooner or later, taxpayer representatives will make inefficiency or lack of accountability a trigger for externally imposed change. And the transfer of many core functions to the European Central Bank must trigger major change at European central banks. Inertia – and its likely consequences of diminished independence and lost credibility -- is simply too big a risk.

## Management Practices

More space would be needed to discuss in detail the organisation and management practices a central bank should apply at the different stages of its development. However a shorthand analysis of differences between the three ages could look like this:

| | First age | Second age | Third age |
|---|---|---|---|
| **Organisational Purpose** | | | |
| Functional focus | Mainly operational | Policy and operational | Policy and "advisory" |
| Priority for delivery to stakeholders | Effectiveness -- doing the right things | Efficiency -- doing things right | Exploration -- influencing things in new ways |
| Typical external relationships | Transactions | Consultation | Partnerships and staff interchange |
| **Structure** | | | |
| Organisation model | Public service | Commercial | "R and D" centre |
| Main way of organising activity | Departments | Processes | Projects |
| "Career" framework | Lifetime career paths and expectations in all areas | Lifetime career paths/expectations in core areas, term contracts in non-core areas | Types and lengths of contract, role and career expectation vary by role and individual |
| Remuneration type | Time-driven salary scales plus major fringe benefits. Little focus on total remuneration. | “Cost to employer” packages that include choice and performance components | Flexible packages tailored around individual contributions and development paths |
| **Management** | | | |
| Main decision type | Quality control | How to do things | What things to do |
| Dominant style and type of interaction | Administration, through hierarchy | Management, through negotiation | Leadership, through facilitation |
| How management adds value | Checking and supervision | Organisation and quality assurance | Sponsorship and coaching |
| How the benefits and costs of services are measured | Activity measures, centralised and partial budgeting, “get what you’re given” services | Output measures, full and delegated budgeting, internal and external service contracts | Same as second age, but with a stronger focus on broader outcomes and “intangibles” |
| **Staff involvement** | | | |
| “Qualification” for direct contributions | Individual rank | Individual role | Individual capability |
| Typical media for direct contribution | Memos and papers | Regular or special purpose meetings | Informal forums, e-mail, Intranet |

The analysis above naturally dramatises differences and neglects overlaps between the three ages. But it is easy to see these concepts working in practice. For example, at your central bank:

- Is external recruitment at senior levels common or rare? What secondments operate outside the world of central banking?
- How closely are rewards linked to length of service? To contribution? Are funds and resources unduly tied up in assets and activities that deliver staff benefits but contribute little to organisational achievement?
- What selection criteria determine management appointments? Do appointments just “shuffle the pack”, or mix in new people with fresh ideas? Are specialists brought in to manage non-core activities?

- Do able staff get early opportunities to tackle challenging assignments? Or are they required to first “serve their time” performing mundane work?
- Are staff expected to share ideas widely? Or do they communicate across organisational boundaries only to process work or through their managers?
- Who attends important or cross-functional meetings, and why? How widely is e-mail used, and for what?

What changes appear to be needed at your central bank?

**Making Change Happen**

Any social organism tends to resist change. But for central banks, the change task is particularly challenging.

Almost by definition, central bankers lack comparative advantage in managing organisational change. Effective change is likely to need fresh perspectives and some form of independent quality assurance. For example, the initial change mechanism at RBNZ comprised external recruitment of a few key senior individuals with change management skills and mandates. Whatever the mechanism chosen, strong sponsorship and project management will be needed to make change real, effective and widely "owned".

Each change program will be different, but a few common steps can be identified.

First, picture the future:

- Realistic long-term functions and outputs
- A corresponding organisational structure and resource base
- Leadership and management practices needed to maintain or attain
    - Effectiveness (in the first-age and second-age functions that remain)
    - Efficiency (managing resources well, and demonstrating that)
    - Exploration (in the areas of greatest future need and interest)

Next, plan <u>backwards</u> from that future. Create and sustain the four key elements of successful strategic change:

- Pressure for change -- "sell" change through strong internal leadership, contrasted with the alternative threat of externally imposed change
- Clear shared vision – communicate the desired future and key milestones along the change path. Focus on positives, without hiding negatives.
- Capability for change -- supply the people and tools needed to lead and support change. Pragmatically combine internal and external resources.
- Actionable first steps -- embark on change sooner rather than later. Seek some "quick wins" that encourage and facilitate further change.

The key initial challenge may be to create a mandate for change and generate a critical mass of support. This will not be easy. Even those who accept their organisation’s need for change may have low motivation or vested interests. Those entrusted with organisational leadership will need to establish a vision, inspire belief in others and when necessary take tough decisions.

Once underway, expect change programs to encounter obstacles. Remember that management is a craft: a creative combination of science and art, rational planning and emotional commitment. Pragmatically quarantine and manage transitional issues in ways that do not compromise longer-term objectives. And most vitally of all, insist that managers personally "walk the talk".

The leadership task of creating and sustaining new organisational values should not be underestimated. It is relatively easy for an organisation to change its functions, job definitions and management systems. But unless organisational values shift, progress is likely to stall. The biggest test of leadership may come when something goes wrong, demanding strong internal action and frank external disclosure.

Creatively apply new concepts to develop the leaders and managers of tomorrow:

- Think of a central bank as an evolving business, not a career bureaucracy. Replace seniority and status with a requirement for continuing added value.
- Move from "succession planning" to capability planning. Aim to build leadership, management and technical skills across a broader base of people
- Accept that capable people now pick whom they will work for, not the other way around. Innovative leaders need not wait around to be anointed!
- Encourage innovation and risk-taking, ideally in projects that stretch people but are not mission-critical. Dream a little.
- Subdue the secrecy reflex. Do not allow real confidentiality needs on a few matters to inhibit sharing other information. Make disclosure and discussion of activities and intentions an opportunity, not a threat.

And while creating tomorrow, do not neglect yesterday and today. Aspects of central banking that need to focus on reliable processes and cost reduction may require quite different management practices from those that have other characteristics. Diversity within a common core of values and concepts is not only feasible, but can provide a stimulating challenge that enriches the whole organisation.

In short, add to the traditional central banking virtues of “integrity, professionalism and public service ethic... (the new qualities of)... "flair, openness, innovation and the imaginative anticipation of future risks and opportunities”.[5] Make that successful transition your central bank’s admission ticket to the third age.

## Conclusions

For all organisations, reshaping capability and performance to meet -- and preferably to anticipate -- external pressures is a continuing challenge. Central banks are no exception, and the changes that are needed can be simply stated. But evidence suggests that the central banking industry as a whole has not yet responded effectively to that challenge. The critical mass of internal enthusiasm and external pressure needed to drive change has been lacking.

Central banks have enjoyed unique freedom to plan and manage internal change, away from the limelight. But that situation is unlikely to persist. Waiting too long or doing too little will in the end be counter-productive. The alternative -- vigorously adopting new values and welcoming scrutiny -- is likely to pay high dividends in central bank independence, relevance and credibility.

The choice should not be hard to make!

[5] Robert Pringle, in the November 2002 issue of Central Banking.

John Mendzela is director of Mendhurst, a consultancy that specialises in the planning and management of strategic change. He led organisational transformation work at the Reserve Bank of New Zealand and has advised a number of central banks on organisation and management change programs, directly or via the IMF. Comments on this article can be sent to the author at johnm@mendhurst.co.nz.