

## Leadership and Management for Central Banking's Next Century

This has been a central-banking century.... The number of central banks has risen from 18 in 1900 to 172 in 1998. The world now has almost half a million central bankers.<sup>1</sup>

The first quarter of the 21<sup>st</sup> century saw central banking become a small, mature and genuinely global "industry". In developing countries, central banks either grew more effective and efficient or disappeared. In more developed economies, central banks lost most of their control functions – some found new roles while others became historical curiosities.<sup>2</sup>

The first quotation is real; the second is hypothetical but far from unlikely. Central banks are acutely aware of the political, economic and technological challenges they face. What receives less attention is how internal leadership and management will be a key determinant in the futures they will create for themselves.

Internal leadership and management have often had a low priority for central banks. As "Governors" rather than "Chief Executives", central bank heads tend to concern themselves mainly with external relationships and activities. Internal leadership and management have usually been delegated to career "central bankers" with mainly technical, not managerial, interests. As a consequence, central banks can lag well behind best practice in organisation and management.

Many aspects of central banking can benefit from a conservative approach to internal management. But in a world characterised by rapid change and a global "war for talent", central banks will need to pay much greater attention to internal leadership and management. That is not easy for them. Central bankers rarely have hands-on management experience from elsewhere. But importation does not necessarily work well either -- the unique features of central banking can confound simplistic management approaches.

The author is an independent business and management consultant from the private sector -- but one who has also worked extensively with central banks to lead or design management change. This article blends an "outsider" perspective with "insider" knowledge to develop change concepts for central bank leadership and management. A further article will discuss efficiency and accountability, and suggest how internal transformation can be successfully planned and managed.

### **The first age of a central bank**

Most central banks emphasise their traditions. These unique and individual histories can however divert attention away from more fundamental concepts. To understand why many central banks need to change their leadership and management practices, it helps to consider the development of a hypothetical central bank.

The founding role of a central bank – its "first age" – emphasises operations. The role is a practical one of providing operational support to a national government and

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<sup>1</sup> The Economist, 28 November 1998

<sup>2</sup> Economic history text, circa 2032

to the institutions and individuals of a national economy. Specific central bank functions are likely to include:

- Issuance of circulating currency (and collection of seigniorage)
- Inter-bank settlement
- Banking services for the government (and perhaps others)
- Management of fiscal instruments
- Other operational services specific to the time and place

In that "first age", the main priority for a central bank is to be effective. Customers and stakeholders seek predictability, consistency and reliability. The central bank is expected, indeed encouraged, to operate as a "bureaucracy" -- in the positive sense of that word.

Internally too, the bank's practices will tend to favour predictability, consistency and reliability. Organisationally as well as operationally, the bank is likely to become a bureaucracy. A "civil service" culture that emphasises tradition, precedent, technical knowledge and job security will develop. Less desirable cultural traits such as hierarchy, conformity, dogma and stressing form over substance are likely to emerge too. But those negative aspects of a bureaucracy do not undermine key first-age functions and so they do not matter greatly. Command and control can deliver effectiveness. The "managers" of a first-age central bank in reality need only to be capable administrators.

Even in that first age, a central bank is not immune from obsolescence. Factors such as technological change, skill shortages and customer expectations can challenge a central bank. For example, internal banking processes at central banks often lag considerably behind technologically more advanced processes in the private sector, frustrating everyone involved in government transactions and making fiscal management more difficult. Or poor management of currency in circulation can attract criticism from businesses and consumers who must handle too many low-value notes of deteriorating quality.

## **The second age**

In its "second age", a central bank is likely to take up new roles that require broader knowledge and more sophisticated judgment. The bank's customers, and its wider political and economic stakeholders, now also require "policy functions" such as:

- Development and implementation of monetary policy
- Management of the nation's foreign reserves and exchange rates
- Regulation and oversight of financial institutions
- Expert advice – perhaps even decisions -- on economic development

Cultural characteristics that once were strengths now readily become weaknesses. Diversity of opinion and free expression become essential tools in policy development. New specialisms favour youth and education over age and experience. Market operations require fast, "frontline" responses that cannot wait for hierarchical decision-making processes. Effective oversight of financial institutions requires business skills and a willingness to look beyond prescriptive rules.

How well are central banks meeting these challenges? A few "war stories" indicate typical issues:

- At one G-7 central bank I asked why so many people with high management rank but little management responsibility -- and only those people -- formulated policy. I was told that it was important to have a wide diversity of views at the policy table, and also important that all those there had climbed a long internal career ladder first so that they "understood what was required". From other conversations it became clear that there was in fact little diversity in policy discussions. Younger staff felt powerless and shut out of the policy process. Management seemed oblivious to the obvious -- that people who climb a narrow and hierarchical career ladder are unlikely to have diverse views by the time they reach its top!
- At another developed country central bank I asked why banking supervisors rarely visited the banks they were individually responsible for vetting. My question puzzled management -- what would be gained by such visits? I pointed out that intuitive impressions gained from on-site visits and individual interviews can be a valuable complement to "hard" data. Management understood and agreed in principle, but said that in practice the career central bank staff engaged in supervision lacked the skills and experience to obtain those benefits from such visits. Unfortunately the same management found many good reasons why recruitment secondment from the private sector was "impossible"....
- A developing country central bank was diligent in seeking statistical information from private industry and feeding this into its policy formulation. Management was proud of the long data series available. However investigation soon demonstrated that this data came from voluntary surveys and many samples had long ceased to be representative. In fact data for one important industry was being collected only from a single small company in a remote location! Procedures were being diligently followed, and no one had been willing to challenge precedent....

As these "war stories" demonstrate, the leadership and management practices that respond best to second-age challenges are typically resisted by a bureaucratic culture. Furthermore the outcomes required from many of the central bank's original functions may remain unchanged, complicating the management challenge. What had been a relatively cohesive institution is likely to become a patchwork of disparate practices and cultures.

To progress, the central bank will need to take a more businesslike approach that balances effectiveness and efficiency. That change is likely to include a thorough rethink of the bank's functions and structures. Overall staff numbers will probably need to fall substantially to respond to functional and technological change, with remuneration structures reflecting economic value not length of service. The standard tools of 20<sup>th</sup>-century business – mission statements, measurable objectives, cost accounting, management reporting, stakeholder accountability and systematic performance improvement -- have to be adapted to the specific needs of the central bank. In the second age, senior staff need to be genuine managers and not just administrators.

## The third age

The shape of the "third age" of central banking is still emerging. But some outlines are already apparent. Most fundamentally for central banks, the "national economy" macroeconomic model that underlies the concept of a national central bank will become steadily less relevant. The balance of economic activity is moving from production of tangible needs to intangible wants. Information and communications technology is altering how economic structures, relationships and transactions operate. And like other organisations, central banks will face the challenges of a complex, technologically advanced and global "knowledge economy".

Third-age functional changes challenge traditional central bank management. Operational functions such as banking that are not unique to central banks move elsewhere, or become more "high-tech" with far fewer people involved. The emphasis of policy functions changes from prescription and intervention to influence and risk management. In all functions, attitudes and experience date more rapidly and information technology plays a more strategic role. Maintaining a "peace time army" that can be truly effective in a crisis becomes harder.

But as the central bank's former roles become less important, a new opportunity emerges. With its unique overview that combines theory and practice, a central bank can explore the practicality of new ideas and consider trends that business and government may be neglecting. "Thought leadership" about economic management can add greater value. "Advisory" roles may even become the central bank's key function as national boundaries diminish and national currencies disappear. Organisational boundaries need to blur as the central bank shares its tasks with external organisations. It will be vital to exchange people and ideas with other sources of expertise, in highly flexible ways.

Staff will expect to work in a creative, team-based environment in which they make a substantial and recognised personal contribution. Internal boundaries need to be made permeable in ways that do not jeopardise security and confidentiality requirements. A businesslike emphasis on goals and performance will still be important, but a more open-ended approach to knowledge management will be needed to encourage those wider contributions. Project sponsorship and management become core skills, not just desirable ones. Creative individual "employment" arrangements will be needed to facilitate movements within the central bank and to and from the outside world.

Like professional service firms, central banks need to replace the concept of an exclusive club with that of an alumni network. Training and development investments require careful thought and innovation. "Career" progression becomes more of a joint responsibility that is jointly funded. The challenge of managing human capital will be greatest at the top.

In developing countries, the move into the third age of central banking is likely to be slower. The balance of risks is likely to demand closer attention to traditional functions, particularly when skills are in short supply. However "thought leadership" will be perhaps even more important -- the central bank will often be the only institution that can capably apply resources to issues that are more important than urgent.

Common shorthand for distinguishing between effectiveness and efficiency is that

effectiveness demands doing the right things, while efficiency demands doing things right. To complement effectiveness and efficiency, the third-age central bank will need to add a new dimension of achievement. We might call that dimension “exploration”. Extending our shorthand, one might say that exploration demands influencing things in new ways. Through exploration, a central bank can do much to help its society make transitions from power to knowledge and from politics to economics.

The ability to direct and coordinate activity towards common purposes will increasingly depend on good relationship management rather than statutory or hierarchical authority. In the third age, senior staff must predominantly become leaders and facilitators, not just managers.

### **Autonomy -- problem or opportunity?**

Central banks undeniably have greater management autonomy than most other entities. Unlike private sector companies, they are not subject to the pressing disciplines of competition. And unlike most other public sector entities, they are usually self-funding and so not subject to direct budgetary control by governments.

An optimist might conclude that central banks are uniquely able to plan and implement systematic, long-term change to their internal management. A pessimistic might say that autonomy makes central banks uniquely susceptible to organisational inertia and staff capture. Both are right.

Autonomy makes it easier to avoid change, in the short term at least. Consciously or unconsciously, it is tempting to pursue self-interest. But there are compelling reasons for central banks to instead follow the optimist's line.

Deferring change is counter-productive. Inadequate or belated internal responses progressively undermine organisational capability. As capability deteriorates, external credibility and esteem will erode. Change will then be demanded and imposed, not just desired and requested.

And the balance of risk is shifting. People and institutions that are seen to put their own interests ahead of stakeholders and customers face increasing penalties and. Governance failings that encouraged short-term expediency have recently devastated highly respected institutions. As an organisation reliant on market reputation and public confidence, a central bank would be unwise to pursue self-interest too far.

The positive reasons for active internal change are equally compelling. Just as inadequate internal responses will progressively undermine organisational capability, superior internal responses will enhance that capability. Independence and autonomy are likely to be maintained, perhaps even increased. New roles are then more likely to emerge as old ones fade.

Example is not the main thing in influencing others. It is the only thing.<sup>3</sup>

Increased external credibility and esteem can be attained too. Central banks often need to dispense unpopular medicine. They frequently preach against economic rigidity and vested interests. The moral authority gained from "we practice what we preach" gives policy advice more weight.

Greater management accountability is likewise an opportunity, not a threat. Governance that seeks to avoid scrutiny is likely to generate suspicion; governance that welcomes disclosure and accountability to stakeholders is likely to be applauded. Disclosure and accountability can be applied positively to spur and showcase internal change initiatives.

### **Implications for leadership and management practices**

How management of a central bank should aim to blend the three dimensions of effectiveness, efficiency and exploration will vary with circumstances. But several general observations can be made.

- Absence of the later dimensions will ultimately inhibit achievement even across earlier ones. A central bank that fails to pursue efficiency – for example by remaining overstaffed and bogged down in bureaucracy -- will resist changes in operational methods and erode its effectiveness. A central bank that fails to pursue exploration – for example by emphasising authority over dialogue in staff relationships -- will lapse into stereotyped policy responses.
- Conversely, virtuous circles of achievement can operate. A central bank that becomes more efficient will almost certainly become more effective as a result. An "early adopter" of exploration concepts will be able to tap a wealth of internal and external creativity across all its functions.
- Progression from operational functions to policy functions to "advisory" functions is not simple and linear. Often it will be the type of involvement, not the function itself, which changes. For example transfer of government banking operations to the private sector changes the central bank's role, but a role still remains as part of monetary management. External change may even rejuvenate historical roles – for example payment and settlement systems require renewed attention as a consequence of globalisation and technological change.
- The pace of change is increasing. This is particularly apparent in challenges to traditional functions. The existence of national currencies has been fundamental to central banks, but it is now plausible to imagine a single world currency. E-money issued by a wide range of business organisations is technologically feasible. Overseeing a global and complex financial system may require entirely new approaches based on partnership principles.

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<sup>3</sup> Albert Schweitzer

- Any social organism tends to resist change. Introversion breeds myopia. Rigid traditions defy change initiatives. Most central banks are likely to need independent perspectives and quality assurance to succeed with their internal change initiatives. Strong sponsorship and good project management will be needed to blend inputs and ensure that change is meaningful, effective and "owned".
- It is relatively easy for an organisation to change its functions, job definitions and management systems. It is far harder to change organisational culture. Unless change management stresses cultural change, progress is likely to stall. Early gains may even reverse. Reversion risk is particularly high when an organisation comes under unexpected pressure.
- Central banks have unique freedom to plan and manage change and transformation. Using that freedom to wait too long or to do too little will be counter-productive. By contrast a vigorous approach that welcomes management accountability is likely to pay dividends.

### **Recent examples**

The benefits to be gained from improving internal management at a central bank have been powerfully demonstrated. At New Zealand's central bank, a program of organisational transformation based on business management principles not only achieved large efficiency gains but also improved effectiveness. The establishment of internal practices very different from those traditional in central banking -- for example fixed-term contracts, selective outsourcing, output costing and publicly reported budgets -- has sparked a steady stream of new thinking and organisational evolution.<sup>4</sup>

Perhaps more importantly, radical internal change helped give the newly independent Reserve Bank of New Zealand the moral authority to take unpopular steps that were essential for urgent and wrenching economic reform. That moral authority remains high today.

The New Zealand example comes from a developed economy. But central bank leadership and management may be even more important in developing or transition economies. It is increasingly clear that successful economic reform demands not just the right policies but also the institutional capability to implement those policies. Rapid shifts to a freer economy may require the simultaneous and accelerated development of effectiveness, efficiency and exploration. The central bank can lead and exemplify change management, or it can become a bottleneck that impedes wider economic change.

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<sup>4</sup> That program's methods and results have been outlined in the author's IMF Working Paper WP/94/37 -- "Improving the Management of a Central Bank -- A Case Study".

## Conclusions

The power of central banks has steadily increased over the past couple of decades.<sup>5</sup>  
.... Never before in history have central banks wielded so much power.<sup>5</sup>

Central banks face a rapidly changing environment. The direct power they exercised yesterday and today will give way to less direct forms of influence.

To respond successfully to change, central banks need to give internal leadership and management a high priority. Internal change will be needed at most central banks, more substantially and more urgently than in the past. Those central banks that vigorously take up this change management task are the ones most likely to achieve continued relevance, independence and success.

What is your central bank doing to meet that challenge?

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<sup>5</sup> The Economist, 25 September 1999