Can central banks be made more efficient?

One of the chapters in Dr Don Brash's recent book "Incredible Luck" outlines his experience as Governor of the Reserve Bank of New Zealand from 1988 to 2002, and the challenges he faced implementing what was then a radically new approach to the relationship between government and central bank. The extract below is part of that chapter and addresses the issue of making central banks more efficient.

Although there may be some exceptions, as a general rule the public sector is less efficient than the private sector in all countries for the very good reason that inefficiency in the private sector is usually punished fairly quickly by competitive pressure. There is little or no competitive pressure in the public sector. On the contrary: many operations in the public sector are effectively monopolies, and moreover they are monopolies which don't have to convince customers of the value of the services they provide. They effectively demand that the public pay for whatever services the public sector provides, at whatever price the public sector nominates, through the tax system.

As another generalisation, central banks are often the most inefficient part of the public sector. And the reason for that is not just the absence of competitive pressure but also because of what is known as seigniorage income. When central banks issue notes and coins, they are effectively issuing promissory notes – promises to pay the value stated on them whenever presented, and it is that promise to pay by the central bank which gives bank notes and coins their value. (In most countries, bank notes and coins have no intrinsic value.) But unlike most promissory notes, bank notes (and coins) carry no interest. So effectively the bank notes and coins held by the public constitute an interest-free loan to the central bank.

During my time as Governor, the amount of the note issue in New Zealand grew from about $1.1 billion to $2.6 billion, both very low numbers relative to the size of the New Zealand economy because for several decades New Zealanders have tended to use non-cash means of payment more than the citizens of any other country I am aware of – initially cheques, and more recently credit and debit cards, and various forms of electronic banking. We took the funds provided by what was in effect an interest-free loan from the public and invested them into New Zealand government bonds. And even with the much lower bond rates which prevailed during my time as Governor (as compared with the years immediately preceding that), that investment produced a very large amount of income. At a bond yield of, say, 6%, the investment of a note issue of $2.6 billion generates over $150 million of income annually – substantially more than was needed to pay for a large staff, reward them generously, and accommodate them in offices which were, certainly by the standards of much of the rest of the public sector, very comfortable indeed thank you. And the same is true for central banks all over the world.

I recall being astonished a few days after I became Governor to be told that I had a car and driver waiting downstairs to take me to my scheduled meeting with the

Minister of Finance. I asked where the Minister was at the time, expecting to be told he was on the other side of Wellington. Great was my surprise when I was told he was in his ministerial office, in the Beehive. (For those who don't know Wellington, the Beehive is about 200 metres from the Reserve Bank building. And it wasn't even raining!)

This was, I regret to say, typical of the central bank's culture at that time. I had just resigned as a director of the New Zealand Kiwifruit Authority to become Governor, and I was acutely aware of the huge financial and emotional pressures which were being experienced by those in the wider economy, especially by those in the export sector. Some parts of the export sector had lost subsidies, and all parts of the export sector were suffering from the very tight monetary policy which the Reserve Bank was operating in order to bring down inflation – interest rates were very high, and the exchange rate, which had been floated in March 1985, had appreciated quite strongly. Some kiwifruit orchardists, and no doubt other exporters, were committing suicide under the pressure. And here were the central bank's own staff continuing to live very comfortable lives, often enjoying mortgages provided by the Bank at very low interest rates. It seemed totally incongruous, and indeed almost immoral.

So quite early on I started to try to make the Bank more efficient, and in this I was greatly helped by Dick Lang, who was then one of the two Assistant Governors and later became one of two Deputy Governors, and John Mendzela, who had been hired as a consultant to assist the Bank's information technology agenda but who later joined the staff of the Bank. I particularly took my hat off to Dick Lang: he had grown up in the "old Bank", where efficiency was almost a dirty word, but he recognised that times had changed throughout the public sector, and he saw it as his responsibility to improve the efficiency of the Bank also.

Over my first two years as Governor, we were able to reduce operating expenses to some extent, despite inflation, and I thought we were making good progress. I was in for a rude shock.

When even quite well informed commentators talk about the Reserve Bank of New Zealand Act 1989, most attention is focused on the primacy it gave to price stability as the objective of monetary policy, or the then-unique relationship it created between elected government and central bank. Almost nobody pays attention to another of its significant innovations. The Act deprived the Reserve Bank of the right to seigniorage income.

When the legislation was being debated, the Treasury argued that seigniorage income should rightfully belong to the Crown, not to the Bank, because it was the Crown's support for the Bank which gave credibility to its promise to pay on the notes. They argued that the Reserve Bank should seek money from the Minister of Finance each year, in the same way that each government department did. We argued in reply that having to go cap in hand to the Minister each year to pay staff and pay for the other costs of running the Bank was to significantly detract from the operational independence which the legislation was also intended to give us. In the end, we reached a compromise – the Governor would negotiate with the Minister of Finance for money to operate the Bank every five years.

The first negotiation was with David Caygill. He asked me what we were budgeting for the first full year of operations under the new Act (1990/91), and I told him $56.7 million – the number is still indelibly burnt into my memory. That was a reduction in the operating costs over the previous two years, and I was pretty proud of the number. Mr Caygill suggested that we take that $56.7 million and grow it by just 1% per annum for the five years of the contract, 1% being the median of the agreed inflation target. I protested, and pointed out that inflation was still running at 5 to 6% per annum, and was not scheduled to get to the 0 to 2% range for a further two years. Mr Caygill insisted that that was all he was willing to agree to.

As if that was not bad enough, before Parliament ratified that agreement, there was a general election and a new government came to power. Ruth Richardson, the new Minister of Finance, had been a personal friend since we had both been National Party candidates in the 1981 election, but there was no way that her personal friendship was going to get in the way of a tough negotiation. She pointed out that she was not willing to agree to the deal I had negotiated with Mr Caygill, and instead demanded that we have no increase in our expenses at all for five years. She noted that she was giving government departments no increase in their budgets. I pointed out that she was able to change the budgets for government departments each year. By contrast, we were discussing a five year deal. But she reminded me that I was committed to price stability, and said she was adamant: no increase in our $56.7 million annual budget for five years.

I walked back to the Bank with a heavy heart.

But over the next few years, I discovered with both amazement and embarrassment that there was much more fat in the system than I had ever imagined. In no single year did the Bank's operating expenses exceed $56.7 million, and indeed in the fifth year of that first contract operating expenses totalled just $35.1 million, 38% below the permitted limit.

In achieving that, I pay a special tribute to Dick Lang and John Mendzela, but also pay a tribute to all the Bank's senior management team, who took it as a matter of pride that they could make the Bank more efficient. We were helped by the way the legislation was specified. The law provided that, if the Bank exceeded the agreed limit in any year, it had to dip into its reserves to fund the excess. Conversely, if we spent less than the agreed limit, the difference was added to the Bank's reserves. So we had no incentive to spend up to the agreed limit before the end of the financial year, as appears to be true in most other parts of the public sector.

We also uncovered one very large source of savings. We had for many years had our bank notes printed by the New Zealand subsidiary of Thomas de la Rue, a very large and well regarded British bank note printing company. We had always negotiated a price to have these notes printed, and we had been assured that we were getting a very good deal. After the passage of the 1989 legislation, and the signing of the first Funding Agreement with the Minister of Finance, we explained to Thomas de la Rue that we were going to have to go to a competitive tender for the supply of the notes. You can't, we were told – we (de la Rue) own the copyright on the New Zealand bank note designs.

It was at about that time that I thought it would be a very good idea to have some new designs on our bank notes. To that date, all New Zealand bank notes bore the portrait of Her Majesty the Queen. Surely it was time to have the portraits of some New Zealanders on the notes? So I invited public reaction to the idea. Not too surprisingly, opinion was very divided – with many people strongly in favour of keeping the Queen on all the bank notes, and others wanting New Zealanders on all the notes. In the end, I decided to retain the Queen's portrait on the most widely used note (the $20 note) but to put New Zealanders on the other four denominations (we had already coined the $1 and $2 notes).

We did not want to be beholden to Thomas de la Rue for the printing of our bank notes. We went to tender for bank notes with the new designs and de la Rue won the tender – but the tender price was about one third less than the price at which they had printed notes for us previously.

In my final year as Governor, the year to March 2002, we were of course in the third Funding Agreement under the 1989 Act. Total operating expenses under the Agreement that year were $24.9 million, 20% below the $31 million limit allowed. Staff numbered about 185, down from about 550 when I first became Governor in September 1988.

That improvement in efficiency had been achieved in a raft of ways. Moving to polymer-based bank notes in the late nineties was part of the story – they were more expensive than paper bank notes, but lasted much longer, and so required fewer staff to process. We changed the way in which we dealt with notes being returned from the commercial banks, and so were able to close our branches in both Christchurch and Auckland. We analysed the cost of everything we did, and so discontinued the issuance of $1 and $2 notes (issuing coins instead – initially more expensive but with a vastly longer life) and the 1 and 2 cent coins. I have not the slightest doubt that, if other central banks were as focused on costs as the Reserve Bank is, a great many coins and low-denomination notes would disappear from circulation and a great many central bank staff would find more productive employment in the private sector.

In short, I am quite sure that central banks *can* be made more efficient, indeed vastly more efficient. The problem is that most central banks have absolutely no incentive to become more efficient.