Governing the Governors – What Really Caused the GFC?

By John Mendzela

Since the "GFC" began five years ago, central banks have been in crisis. How did that happen? Has something gone wrong with central banking?

The "Global Financial Crisis" was not one. A crisis is short and sharp. The GFC can instead be seen as a "Global Fundamentals Check", when an unsustainable boom in leveraged assets ended. The **NICE** times - **N**on-**I**nflationary **C**ontinuous **E**xpansion – are over.

Most developed economies now face **NASTY** times: **N**ightmare of **A**usterity and **ST**agflation for **Y**ears. Increasingly desperate attempts by governments and central banks to pretend otherwise have failed. Inevitably so. Any economics student can demonstrate that economic growth based on accelerating debt must falter if debt is stabilised, never mind lowered. We must expect some leaner years in a "new normal".

How far central banks, who also primarily or partially regulate financial services, should bear blame for the GFC is arguable. In hindsight, they could have done more to stop the economic game getting out of hand, especially in banking regulation. But much debate about policy failure in central banking and financial regulation misses the point.

Any institution and any regulatory system are operated by people, who are organised and managed under a system of governance to perform their operational roles. Good governance should deliver sound organisation and management, which in turn should deliver effective operations.

Central banking has increasingly emphasised, and achieved, high technical expertise. So its “policy” failures were, almost by definition, more failures in governance than technical expertise. What is wrong? What inherent strengths and weaknesses can be observed in central bank governance? And what lies ahead?

The governance of central banks is often surprisingly historical and haphazard. To generalise, central bank governance has been designed mainly around monetary policy, with other functions underestimated and institutional governance an afterthought at best. Three models can be broadly distinguished.

Under a “company model”, the central bank’s single board comprises one or several full-time internal directors (typically the governor and deputies) and a larger number

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of part-time external directors. The central bank is accountable, through its board, to a government minister. Parliament may have some involvement, for example through committees, but there is no higher governance body than the central bank's own board.

Under a "supervised" model, the central bank has two boards. An operating "board", led by the governor, works internally and with continuity. An accountability board operates at a distance and more occasionally. The operating board usually comprises internal full-time professionals, while the accountability board usually comprises more political representatives.

Under an "in-house" model, the central bank has a single board comprising full-time appointees. Those "directors" are mostly appointed from within the central bank, and usually lead specific departments. External accountability operates as in the company model.

The inherent disadvantages and deficiencies of an "in-house" or "supervisory" governance model are obvious. The first confuses governance with management, and the second invites ineffectiveness and conflict. And even the "company" model is not always operated well in practice.

So there is much room for improvement in the governance models and their operation. Interested readers can find an extensive analysis in "Improving Institutional Governance in Central Banks" at www.mendhurst.com/centralbanking.

But models are all about structure and process. We know that even "good governance" structures and processes can fail to realise opportunities, or deliver visibly disastrous outcomes. Good governance can only be achieved by the right people working in the right way. Fundamentally, good governance depends on capability, character and culture.

How does central bank governance look against a more general concept of "the right people working in the right way"? In business, the key qualifications for non-executive directors are simple and threefold: business acumen, integrity and common sense. Those same qualities should imbue any board's collective activity. Does central bank governance display them?

Integrity is remarkably high at central banks. One normally finds professionalism, even in countries where corruption is rife and high personal ethics are rare. There are exceptions where a power culture dominates all national institutions. But even then, central bankers often take a stand and try to mitigate excesses.

Business acumen, or at least business experience, is much rarer. Monetary economists with little experience of running real businesses usually dominate policy-making. Perhaps more surprisingly, few financial services regulators have much commercial experience in that industry.

Does that matter? Yes. Business acumen is valuable at any time, but especially in decision or crisis. The intellectual humility to "know what we don't know" must combine with courage to act pragmatically on disciplined intuition. Central banks can do much to bring business acumen into their organisations, for example through greater use of flexible career paths, secondments and external advisers. But underlying all such specific techniques is a general principle that central bankers

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need to focus less on their uniqueness and interact more with the external world in inclusive and generalist ways,

What about common sense? As they say, it is not all that common. Questions like "Are increases in asset prices part of inflation?" should not be approached too theoretically. The commonsense answer that of course booms in asset prices are in some sense inflationary was often denied, or at least ignored. So central banks were reluctant to act pre-emptively when consumer price inflation was subdued but asset prices inflated unrealistically.

Any problem (and indeed life) can be approached at three levels

1. simple and superficial – the initial naive response
2. complicated and profound – where technical expertise usually goes
3. simple and profound – where governance should firmly stay!

Simple and profound conversations that should have occurred in central bank boardrooms often didn't. For example:

- “Risk doesn't go away just because it is moved around through clever financial instruments. Where is it in the financial system? What are we doing about that?”

- “How can the “value added” by the financial services sector be such a huge and growing chunk of the total economy?”

- “How did banks from tiny Iceland become so important in the European financial system? How are we managing that risk?”

Non-technical conversations force specialists to think in broader terms and challenge technocratic or theoretical assumptions. They generate fresh thinking, earlier action and better real-world outcomes.

More basic governance errors were prominent too. The US Federal Reserve became dominated by an ideology that markets could not get it wrong and a celebrity cult around Chairman Greenspan. So the Federal Reserve discouraged dissident views and failed to avert looming disaster. That was not a policy error, but a governance failure familiar to anyone who has observed a company with belief in its technical excellence and a dominant leader.

What lies ahead?

Central bank governance is, rightly, under pressure to improve. Benchmarking against general practice is feasible and valuable. Real-world judgment and customisation are essential though – the "company” model may be constitutionally impossible to apply, or separating Chairman and Chief Executive roles might be counter-productive.

Pressure on central bank governance can disguise other agendas. Few openly advocate a return to the days when central banks were the operating arms of finance ministries. But governments keen to inflate away debt or prime economic pumps can use accountability and budgetary levers to undermine the independence of their central banks. Many are doing just that. As a non-executive director at one central bank told me: "our government is committed to a central bank that is independent – but obedient…".

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The future policy and operational environment is demanding. We know now that sole focus on monetary policy – expressed as "price stability" – was unrealistic. The twin-track requirement to balance monetary policy and financial system soundness never went away. But the real elephant in the room is fiscal policy. It is sad to see respected central banks funding their governments on an enormous scale (under various technocratic euphemisms of course). The prohibitions imposed on many developing countries in recent decades through new central bank laws could usefully be applied to their originators!

So central bank governance must play catch-up, under difficult conditions. Policy and operational success will be far more likely with stronger attention to institutional governance and management, so that technical expertise is optimally applied. Most fundamentally, demonstrably effective governance that balances technical excellence with wider perspectives will be essential to retain independence.

As the GFC reminded us, simplicity is a better working principle than complication. The current tendency for central banks to become over-scientific in pursuing better governance and management is unhelpful. In these practical business disciplines, pragmatism not intellectualism should rule. The goal should not be some "best practice" model, but “good practice plus customisation” that will optimise “right practice for us”.

Central bank boards face difficult paths. In a challenging and changing environment, central bank directors will need all of their integrity – plus strong measures of the business acumen and common sense that are hallmarks of good governance!

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Annex 1 – A retrospective

The Reserve Bank of New Zealand (RBNZ) was an early mover in improving institutional governance and management. Have those reforms stood the test of time?

Yes. RBNZ's statutory mechanisms for governance, accountability and disclosure under a "company" model are still amongst the best around. The 1989 framework has evolved and matured, from a first iconic Governor under a reforming government to credible succession under first a domineering government and now a populist one.

Has that framework delivered? Of course there are naive cries for RBNZ to somehow manipulate the global economy and deliver an ideal combination of exchange rates, interest rates, financial system soundness, improved motherhood and tastier apple pie. But by any objective measure, RBNZ has over an extended period done as much as one could reasonably expect from a small player. That a wide range of foreign lenders and investors will finance a nation with a dreadful balance sheet after 40 years of deficits speaks highly for its institutions.

What should lie ahead? All central banks face major challenges in monetary policy (which includes the exchange rate) and financial regulation. And the RBNZ has only limited scope - successes or failures elsewhere will shape the big outcomes. Optimisation within those constraints may not be exciting, but it is nationally important.

What about the elephant in the room? In fact New Zealand has two elephants – the unsustainable national accounts of New Zealand Incorporated, and the renewed enthusiasm of government for its credit card. Central banks are often economic advisers to government, and most have formal duties to advise against fiscal policies that are likely to compromise monetary policy. Central bankers are however culturally conservative and cautious, and RBNZ has been reluctant to speak vigorously outside a narrower brief. But with single-focus central banking now substantially discredited, there are opportunities for New Zealand's central bank and its new Governor to show industry leadership again.

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Annex 2 – New directions?

Central bank cultures tend to be technocratic and intellectual, sometimes even arrogant. In a technocratic environment, institutional governance and management is easily seen as boring or unimportant. Governance and management input from business people made familiar with the specialist work of central banking is a vital but often undervalued counterweight.

In recent years, central banks have experimented with different approaches to institutional governance and management. Broadly speaking, those new directions commendably tend to apply more businesslike thinking. For example, the venerable Bank of England recently announced its intention to appoint "a Chief Operating Officer … (who) will take responsibility for the day to day management of the Bank, including the oversight of the Finance, Information Technology and Human Resource functions. This will allow the Governor and Deputy Governors more time to focus on their policy responsibilities."

That rationale sounds attractive. But is it realistic? Historically, many central banks operated under legislation that created a position of "General Manager", with just that rationale. In practice, that model failed. Departments and Governors just developed workarounds that made the formal decision structures and processes ineffective. At one central bank I worked with, everyone had forgotten that a "General Manager" even existed – I discovered him only after some days, doing nothing in a remote office!

Certainly better structural solutions can help. But central bankers cannot escape the necessity to be capable institutional directors and managers, not just leading technical lights. Effective governance and management relies on simple modern principles of individual leadership and collective action. The challenge is ultimately behavioural. For example:

- send clear signals – through personal example, not just rhetoric – on cultural values such as teamwork and communication style
- give people room to grow, even err. Resist the temptation to "step in" and become over-involved in urgent issues or responses
- avoid "turf protection". Take a whole-of-institution view of resourcing
- emphasise collective decisions, not individual technical views
- accept, indeed invite, evaluation and criticism.
- make error an opportunity to improve, not an embarrassment to disguise

The challenge is greatest at top level. Central banking traditions do not encourage structured performance management at senior levels, but that is precisely where leadership and management disciplines may be needed most. The first steps are relatively simple. Does your central bank report strategic performance measures for institutional functions, or only KPIs for departments? Are there "job descriptions" for Governors? Is there a charter that outlines how the Board should add value? Simple tools can generate rich discussions that help institutional governance and management modernise and evolve.

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