

Central Banks Leadership and their Influence over Financial Markets

~ Ph. D. Teaching Assistant **Valentin Mihai Leoveanu** (Faculty of Administration and Business, University of Bucharest, Romania)

E-mail: valentin.leoveanu@faa.unibuc.ro

Abstract: *In the years after the global financial crisis, central banks have undergone to a tremendous pressure from financial markets, from the real economy, but also from the population and politicians. Each part is interrelated with each other, but is in different positions in terms of the influence exerted on the other, in terms of the means and instruments through which their interest must prevail against the other parties. In this context, the leadership of a central bank is the key to the proper functioning of a central bank and also to its effectiveness and efficiency. Based on the central bank functions and on some important principles of decision and action, such as independence, transparency and accountability, the leaders of the central banks should provide guidance for the national economy in turbulent times. As a result, the main focus must be concentrate on aspects like: monitoring policy performance, monitoring efficiency of resources, setting functional goals, managing capital adequacy, balance sheet and liquidity, awareness of external perceptions and reputational risks, ensuring good institutional governance.*

Key words: central bank functions, policy formulation and decisions, effectiveness and efficiency of institutional governance, anticipating and avert new challenges, accountability and transparency

JEL Classification: E50, E52, G20, G28

1. Introduction

In the years after the global financial crisis, central banks have undergone to a tremendous pressure from financial markets, from the real economy, but also from the population and politicians. Each part is interrelated with each other, but is in different positions in terms of the influence exerted on the other, in terms of the means and instruments through which their interest must prevail against the other parties. In this context, the leadership of a central bank is the key to the proper functioning of a central bank and also to its effectiveness and efficiency. Based on the central bank functions and on some important principles of decision and action, such as independence, transparency and accountability, the leaders of the central banks should provide guidance for the national economy in turbulent times. As a result, the main focus must be concentrate on aspects like: monitoring policy performance, monitoring efficiency of resources, setting functional goals, managing capital adequacy, balance sheet and liquidity, awareness of external perceptions and reputational risks, ensuring good institutional governance.

2. Central Bank Functions and leadership

There are many controversial debates about the functions of a central bank because, in fact, that depends on the relationship between the central bank and the political power, especially the government, and it is linked with the level of economic development in the country and its historical roots. Many researches and paper works have tried to highlight the basic functions of a central bank but an IMF paper (Collyns, 1983) has

summarized properly this fundamental aspect by categorizing the functions as well:

- Currency issue and foreign exchange reserve management;
- Banker to the government;
- Banker to commercial banks;
- Regulation of the financial system;
- Monetary and credit policy.

Starting this functions of a central bank, there are some important principles of decision and action, namely:

a) Independence. Economic theory and international practice shows that independent central banks can take two forms: independence in decisions regarding the targets (independence in wider sense) and the instruments used and independence regarding the instruments used to apply the government targets (limited independence). In this regard it has been established organizational principles that have defined several features highlighting the degree of central bank independence, such as:

- Statutory guarantees of independence;
- Mentioning the position of independence from the government in the status of the central bank;
- Methods for appointment and dismissal of the governor;
- Length of holding the position of governor;
- Presence or absence of government officials in the central bank's management;
- How central bank is limited by government regulations;
- Central bank limits to finances the government;

How government can alter previous decisions of the central bank.

b) Transparency. The way the central bank provides the government, the general

public and the markets with all important information on its strategy and policy decisions must rely on an open, clear and timely manner of communication. Transparency helps public and institutions to understand better the central bank policies and actions and, therefore, it makes those more credible and predictable.

c) **Accountability.** As an independent institution with public functions, the central bank must be accountable to general public and to the parliament for the conduct of its policies. That means the central bank has a statutory obligation to report regularly about their assessments, decisions and actions i.e. quarterly reports, governors speeches and regular press conferences to the public.

Following the objectives and functions that must meet a central bank on the basis of applying the above principles, a central bank leadership must appeal to a wide range of methods, techniques and tools to put into practice the settled commitments.

They will be put in practice in different manners depending on human typology, the level of knowledge and managerial situation involved.

In this respect, they will follow:

- precise definition of objectives to be achieved through leadership;
- information transmission in order to raise awareness and knowledge, to attract and to persuade subordinates
- tasking leader and subordinates depending on the objectives of leadership;
- delegate the tasks, powers and authority;
- implement of the mentoring and guidance to increase the potential for professional development of subordinates;
- attracting informal leaders to achieve the targets;

making coalitions with leaders from other public institutions and from the government.

Leadership in a central bank should be based on management benefits in terms of organizational effectiveness, mutual trust between employees, application of effective motivation methods and promoting team spirit. In that way, it is important to take into consideration: analyzing the performance criteria to assure an equitable distribution regarding bonuses, training, promotion; achievement of motivation and communication systems based on mutual trust; team building to encourage team spirit and getting the group performance through individual performance.

3. Central Bank and their role on Financial Markets

Central banks currently meet a rapidly changing environment and to respond successfully to these changes, they must put more emphasis on leadership.

The constraints faced by central banks relate to (Menzela, 2003):

- Improper organizational structures in order to support actual functions well;
- Overload tasks at the top management as a result of insufficient and ineffective delegation;
- Incapacity of attracting and retaining talented employees;
- Proliferation of departments based on growing resource levels;
- Inappropriate remuneration to long-serving staff at an above-market level.

That kind of constraints and mistakes that central banks have done in the years before financial crisis brought into attention

some lessons for the future (Menzela, 2009):

- Central banks and regulatory agencies failed;
- Central banking is increasingly a global activity, not a national one;
- Governance perspectives need to be simple and profound;
- Regulation can only succeed with streetwise regulators;
- Efforts to modernise institutional governance and management in central banking have achieved little.

As a result, the main focus must be concentrate on aspects like: monitoring policy performance, monitoring efficiency of resources, setting functional goals, managing capital adequacy, balance sheet and liquidity, awareness of external perceptions and reputational risks, ensuring good institutional governance.

Monetary policy is a means of maintaining price stability and fighting inflation, but should accompany fiscal policy in regulating growth. Therefore monitoring the use of monetary policy instruments and their effectiveness is an objective in order to achieve a good leadership conduct of a central bank.

Setting a feasible target for monetary policy and its fulfillment must be rigorously based on:

- accumulating a gain of credibility of the central bank and its consolidation;
- exchange rate flexibility and reducing the vulnerability of the economy to fluctuations of this variable;
- healing and strengthening the banking system and increasing bank intermediation;
- enhancing transparency and accountability of the central bank and the scope and intensity of communication with the public and financial markets;

- wider analysis of macroeconomic behaviors and economic mechanisms for identifying the correct functioning of the economy and increasing the effectiveness of monetary transmission channels.

In conducting money market operations the central bank has a regulatory role. The money market is a market where central bank provides liquidity by delivering currency against a promise of reimbursement in the short term, i.e. the credit. So credit is granted by central bank money.

Thus, when the market, considered by algebraic sum of global operations, manifests as the requesting central bank currency it is said to be "en banque", that means market liquidity is assured by the central bank that can satisfy liquidity demands. In the other case, the market is "out of the bank" ("hors banque") if it has a surplus of global liquidity, thus market is outside the control of the central bank.

Money market participants are polarized between the central bank and other banks. The central bank policy defines the interbank market by the interests they defend. The central bank may intervene in the money market either by setting the level of interest, either by setting loan volume. In respect of its interests, according to the monetary and credit policy, central bank intervention can be very active or, on the contrary, one marginal.

Short-term interest rate is the instrument by which a central bank makes its monetary policy operations. Typically, the central bank sets monetary policy rate conditioned by developments in the macroeconomic environment in order to achieve its final goals of price stability and financial stability. Management of aggregate demand operates through various transmission channels one

of which is monetary policy rate affecting all asset prices, net of balance sheet items and banks' lending behavior.

Not only short-term interest rate influences the decision taking process of companies, households and governments. A whole set of different interest rates by maturities affect debt management decisions. Aggregate demand is mainly driven by the movements of long-term real interest rates. Taking as a basis the monetary policy interest rate, the term structure of interest rates assumes an important role for maintaining effective monetary policy.

By R. Fendel (2007), essential for monetary policy conduct are three elements closely linked and that occurs in the presence of the yield curve effects. First, bond prices and other financial assets prices reflects market views about the future, providing timely information and insight on a number of macroeconomic and financial factors that are fundamental by their importance for decision makers of monetary policy. Secondly, given the importance of the yield curve in monetary transmission channels through which monetary policy decisions affect the term structure of interest rates and, in turn, other variables units, must be fixed from top to bottom. Finally, the implementation of a monetary policy strategy can be described by a short-term reaction function, either derived from a simple rule, for example Taylor's rule or from a routing rule like the strategy of flexible inflation targeting.

4. Influence of Central Bank Leadership over Financial Markets

A main question arises concerning leadership and management of a central bank

and that is: who are the people that are considered to be as influencing factors in a central bank? The answer is multiple but first of all refers to the Governor.

The governor of a central bank must be characterized by extreme discretion and the ability to say what is need to be said, neither more nor less and those are mandatory qualities. There is a mix of qualities that might be needed at senior levels in a central bank like the ability to decide about a wide range of economic and financial data and information and analyze them with open mind and vision on the future.

A central bank governor must have expertise in areas like monetary policy and financial stability, supervision of banks and payment systems. He must be able to explain clearly to politicians and the general public how it is carrying out the policies actions through complicated tasks and must have diplomatic skills in order to prevent clashes between the bank's policies. Governors do need to understand how national and global financial markets works, both in a technical sense and also in terms of psychology of markets participants. Also the task of explaining and defending policy decisions is more and more important for their approval in parliament or in public forums and the media.

"Today's ideal governor is therefore a first-rank macroeconomist who also understands financial markets, albeit one open-minded enough to listen to dissenting views, who has experience of chairing meetings, and who has a stubborn streak, yet also a silver tongue." (Davies & Green, 2010).

Besides the governor, a special importance in the order of their rank has the Deputy Governors, the subordinated directors and the central bank spokesman.

The behavior of those charged with making decisions about what action to take includes the need to persuade others, including the markets, in that way to convince them central bank decisions are appropriate, without any doubt of uncertainty and not put into question. There is a promotion of a belief in infallibility of the decisions and actions taken by central bank leadership.

The process of generating public statements remains highly disciplined and requires sticking to the official point of view even it is appeared not to be a positive virtue in being repetitive to the general public.

There is also a desire to make no mistakes at all and so, communication and transparency to the public could appear full of ambiguity as a way to keep options open for further developments in actions taking.

REFERENCES:

1. **Basno, Cezar; Dardac, Nicolae**, "*Gestiune bancară*", Academia de Studii Economice, București (2001)
2. **Davies, Howard; Green, David**, "*Banking on the Future. The Fall and Rise of Central Banking*", Princeton University Press, New Jersey (2010)
3. **Nicolescu, Ovidiu; Verboncu, Ion**, "*Fundamentele managementului organizației*", Editura Tribuna Economica, Bucuresti (2007)
4. **Menzela, John**, "*Lessons from the crisis for central bank management*", Last modified 2 Mai, 2015, <http://www.mendhurst.com/download/Management-Lessons-from-the-2007-Crisis.pdf>
5. **Menzela, John**, "*Leadership and management in central banking*", Last modified 2 Mai, 2015, <http://www.mendhurst.com/download/central-banking-2.pdf>