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ScienceDirect
Journal of Comparative Economics 36 (2008) 388–411
Journal of COMPARATIVE ECONOMICS
www.elsevier.com/locate/jce

Why separate monetary policy from banking supervision?

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Received 17 April 2007; revised 21 January 2008

Available online 1 February 2008

Franck, Raphaël, and Krausz, Miriam—Why separate monetary policy from banking supervision?

This paper provides a political-economy explanation for the separation of monetary policy from banking supervision by examining whether this institutional arrangement serves the platforms of the Conservative or of the Liberal parties, which are assumed to favor a stable price level and non-stable prices respectively. This paper shows this institutional design best serves the objectives of the Conservative party, provided the probability of banking crises is low. Thus this paper explains why European Monetary Union member states, which have led low-inflation policies since the mid-1980s, retained national Banking Authorities to supervise their banking systems when they created the European Central Bank. *Journal of Comparative Economics* **36** (3) (2008) 388–411. Bar Ilan University, 52900 Ramat Gan, Israel.

JEL classification: G28; E58; P16

Keywords: Banking regulation; Central banking; Conservative policymaker; Liberal policymaker

1. Introduction

In order to analyze the optimal design of monetary policy, Persson and Tabellini (1993) and Walsh (1995) use a principal–agent framework to determine the incentives that the government should provide the central banker in order to induce socially optimal policies. In these studies, the Central Bank is independent from the government. However, the independence of the Central Bank is seen as not being sufficient for achieving optimal policies. Faced with the wrong incentives, the central banker may implement sub-optimal policies.[1]

Alternatively, the design of monetary policy may be viewed in light of the rational partisan theory studies starting with Hibbs (1977) and Alesina (1987, 1988). In this line of research, which was extended by Grilli et al. (1991), Lohmann (1998) and Lossani et al. (2000), among others,[2] parties in office decide on an organization of monetary policy that allows them to easily tamper with the conduct of monetary policy.

However, studies on the design of monetary policy have so far overlooked the role of banks in channeling monetary policy. If monetary policy is to influence the economy, it must be efficiently channeled by a stable banking

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[1] See Walsh (2000, 2003) for a thorough discussion of monetary institutional design.

[2] See also the surveys by Drazen (2000) and Persson and Tabellini (2000).

0147-5967/$ – see front matter
doi:10.1016/j.jce.2008.01.002

system. Therefore, the supervision of the banking system should be as crucial to political parties as the organization of monetary policy itself.

In this paper, we analyze whether the separation of monetary policy from banking supervision, and the according creation of a Banking Authority distinct from the Central Bank, is the institutional design which best serves the political platform of parties that favor or disapprove of inflationary policies.[3] We model the interaction of monetary policy and banking supervision in an institutional framework where the party in office delegates the control of monetary policy and banking supervision.[4]

There has actually been in recent years a tendency to deprive Central Banks of their authority in matters of banking regulation and institute bodies for that specific purpose. Under this arrangement, Central Banks are assigned the conduct of monetary policy and remain lenders of last resort. This phenomenon has occurred in a few countries, notably Great Britain, Japan and South Korea. Countries which belong to the European Monetary Union (EMU) have de facto adopted this system since monetary policy is now carried out at the federal level while banking supervision is undertaken at the national level. However, the US Federal Reserve Bank (FRB) still plays a major role in banking supervision.

Several empirical studies discuss the relevance of separating monetary policy and banking supervision.[5] Goodhart and Schoenmaker (1995) examine whether the manner in which bank failures were handled significantly varied according to the structure of banking supervision. A similar line of research is taken by Di Noia and Di Giorgio (1999), whose study also assesses how differences in the structure of banking supervision entail different outcomes by analyzing international differences in banks' balance sheets and in inflation. By focusing on the structure of bank supervision in the United States, Peek et al. (1999, 2001, 2003) analyze how the American regulatory structure entails different levels of informational synergies for the various supervisory authorities. They consider that monetary policy is likely to be more efficient when it involves supervisory information on the banking system. However, Ioannidou (2005) argues that this may not necessarily be the case. She provides evidence that the Federal Reserve System's monetary policy actions affect its banking supervisory activities, notably showing that the Federal Reserve System loosens banking regulations when it tightens monetary policy.

In this study, we consider two political parties that are both concerned with banking stability but whose platforms differ on the level of inflation that should be set in the economy. We examine whether they are more likely to fulfill their political objectives if they provide with incentives one agent entrusted with two tasks, i.e., the Central Bank in charge of both monetary policy and banking supervision, or to two agents who are separately entrusted with one task, i.e., the Central Bank which is delegated monetary policy and the Banking Authority in charge of banking supervision.

In line with Walsh (1995), parties offer a state contingent wage contract to the head(s) of the Central Bank and/or of the Banking Authority which provides them with an explicit payment on the basis of observed outcomes. Therefore, we assume that both the heads of the Central Bank and the Banking Authority may induce socially sub-optimal policies, e.g., banking crises, when given the wrong incentives, and that the agents' incentives are dependent on the state of the economy.

In such a framework, we find that the parties' decision to separate monetary policy from banking supervision depends on the soundness of the banking system. In turn, parties with low-inflation policies are shown to prefer separating banking supervision from monetary policy if the probability of a banking crisis in the economy is low. Thus, our results make sense of the separation of monetary policy from banking supervision in Great Britain and EMU member states, which have a sound banking system and have conducted low-inflationary policy since the mid 1980s.

The rest of the paper is as follows. Section 2 describes the model. Section 3 presents closed-form solutions. Section 4 provides numerical simulations. Section 5 concludes.

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[3] Related studies to this paper are those of Kroszner and Strahan (1999, 2001). They discuss how banking supervision and regulations have been successively shaped in the USA as the result of politicians' partisanship and ideology, as well as banks' conflicts of interests. For studies on the link between financial structure and monetary policy in Western and Eastern Europe, see Cecchetti (1999) and Elbourne and de Haan (2006).

[4] Formally, this paper builds on contract theory, a research field that has already been used by Laffont and Martimort (1999) to assess the effects of separation of regulators on economic outcomes. Their perspective however differs from ours since they focus on the creation of several governmental agencies as a means to reduce regulatory capture. See also Laffont (2000) who discusses the making of an optimal constitution from a mechanism design approach. For a survey of contract theory, see Laffont and Martimort (2001).

[5] See also the non-formal studies of Briault (1999), Ferguson (2000), Fourçans (1994), Haubrich (1996) and Goodhart (2002).