Financial Regulation, Supervision and Central Banking: Does Political Economy Explain It Better?

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Motivation

• Goal: “Lead the Discussion on the Topic” presenting the State of the Art
• General Remarks and Specific Examples
Bottom Line

• **Topic:** Financial Regulation, Supervision and Central Banking = Institutions & policies = **RSC** variables

• The State of the **Art:**

• **Two** Approaches: Economics vs Political Economy

• **Three** Intertwined Aspects: Theory, Institutions and Empirics
Background Articles

- Financial System Risk: Taxation or Regulation?, *Journal of Banking and Finance*, 2013, (with F. Passarelli)
- Reforming Financial Supervision and the Role of the Central Banks, *CEPR Policy Insight*, 2009, (with M. Quintyn)
- Politicians and Financial Supervision outside the Central Bank: Why Do They Do it?, *Journal of Financial Stability*, 2009
Topic

• “Conventional” Fields:
  • i) Central Banking and Monetary Policy
  • ii) Financial Regulation

• “Unconventional” Field:
  • iii) Supervision

• Driver: Light Touch Regulation Approach
Supervision (1)

Source: Masciandaro and Quintyn 2013
Supervision (2)

Figure 1a - Number of papers on supervision in journals

Source: Masciandaro and Quintyn 2013
Economics and RSC Variables

• Given a RSC Variable:
• Economics: given the Social Planner, we obtain the optimal level of RSC*
Political Economy and RSC Variables

- Political Economy: Two Views:
  - A) Voter View
  - B) Politician View
Voter View

• Given an **heterogeneous** population of voters:

• **Result:** The **effective** level of the RSC variable can be **different** from the social optimal one

• Example: Masciandaro and Passarelli (2013)

• RSC Variable = the level of financial regulation and/or taxation against systemic risk
Politician View (1)

• Given i) a delegation process between citizens and public actors and ii) heterogeneous types of public actors

• Three Possibilities:
  • HH Politician (career concerned player, relevant interest = median voter)
  • GH Politician (career concerned player, relevant interest = lobby)
  • Bureaucrat (career concerned player, relevant interest = self interest)
Politician View (2)

- Result: The effective level of the RSC variable can be different from the social optimal one
- Example: Masciandaro 2009:
- RSC Variable: central bank involvement in supervision
- Relevant players: HH & GH Politicians
Politician View (3)

• One **more** step: More complex delegation processes between politicians and bureaucrats:
  
  • 1) multi-agents delegation 
  • 2) multi-principals delegation 
  • 3) multi – principals and multi-agents
Politician View (4)

• Example 1: Boyer and Ponce 2012
• RSC variable: banking supervisory setting
• Relevant players: HH Politician + Bureaucrats

• Example 2: Trebbi et al. 2013
• RSC variable: regulatory policy
• Relevant players: HH & GH Politicians + Bureaucrats
Follow up: It Takes Two for a Tango

- The *endogeneity* of the RSC variables can depend on:
  - 1) Social Planner choices *(benchmark)*
  - 2) Voter choices
  - 3) Politician/Bureaucrat choices
Institutions

- **Whatever** the theoretical approach is
- It is important to **measure** the RSC variables
- In order to **test** the theory
- **Fields:** CB governance (independence, accountability), Regulatory Settings, Supervisory Architectures
- Example: Caprio’s contributes on regulation and supervision
Metrics of the RSC variables

• Rules of the Games:
  • 1) Theoretical Consistency
  • 2) Information Richness
  • 3) Transparency (Replicable Results)
Empirics

• *Whatever* the RSC variable of interest is
• It can be used as:
  • *Independent* variable as driver of macro performances
  • *Dependent* variable to explain
• Examples: empirical literature i) on regulation ii) on central banking i) on supervision
Conclusion (1)

- Political Economy Approach: Very Promising Methodology
- Economics and Political Economy: Two Sides of the Same Coin
- Intertwined Perspectives: Theory, Institutions and Empirics
- Graphically …
## Conclusion (2)

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<th>Institutions</th>
<th>Empirics</th>
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