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Combining Bank Supervision and Monetary Policy

by Joseph G. Haubrich

Pardon him Theodotus: he is a barbarian, and thinks that the customs of his tribe and island are the laws of nature.

— George Bernard Shaw,
Caesar and Cleopatra, Act II

Many American organizations, from corporations to government agencies, have reengineered themselves, rethinking their businesses from the ground up. On a larger scale, the former Soviet Bloc countries are in the process of transforming their entire economies—and governments—as they join the free world. Developing countries reengineer as they modernize.

Bank regulation and monetary policy form a key part of this basic restructuring, and countries, like corporations, have several models from which to choose. The central bank of the United States combines monetary policy and bank supervision. The Federal Reserve Act established the Federal Reserve System to "furnish an elastic currency," but also to "establish a more effective supervision of banking."[1] In Germany, the Bundesbank conducts monetary policy, but the Federal Banking Supervisory Office (FBSO) regulates the banks.

Are there good *economic* reasons for combining or separating monetary policy and bank supervision? This article reviews the various arguments and attempts to put them into perspective. It also presents some other reasons behind the diverse choices that countries have made, because, in the end, economics is only one element of the picture.

Geography

No obvious line divides those central banks that combine, and those that separate, monetary policy and bank supervision. In the United States, the Federal Reserve combines these two functions, but the Office of the Comptroller of the Currency (OCC), the FDIC, and individual state banking departments also supervise banks. In Germany, the Bundesbank collects and processes banking information, even though the FBSO is the primary regulator, and private accounting firms are responsible for most of the on-site supervision. In Japan, the Ministry of Finance is the chief regulator, but it alternates on-site inspections with the Bank of Japan.

There are even differences between official responsibilities and actual practices. In Germany, the central bank and the FBSO consult closely with each other, often collaborating on regulations. In Japan, banks treat the "suggestions" of the Bank of Japan as binding regulations.[2]

Still, after all the judgment calls, central banks do tend toward one camp or the other, as table 1 makes clear. The 24 countries listed cluster around two traditions: Those with an English influence, including the United States, the United Kingdom, Australia, and Hong Kong, generally combine monetary policy and

In the United States, the Federal Reserve has responsibility for both monetary policy and bank supervision. Other countries separate these functions to varying degrees. What lies behind this global diversity? Should a central bank be charged with conducting monetary policy and regulating banks, or does it make more sense—both economic and political—to keep these activities separate? The answer is not a simple yes or no. Rather, it appears that the right choice depends on a country's prevailing conditions, including its financial system, its political environment, and the preferences of the public.

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supervision. Countries with a more German influence, such as Austria, Germany, Denmark, and Switzerland, prefer separation. Canada also maintains separate functions, despite its past links to the United Kingdom and France, both of which have opted for combination.

In part, these different traditions reflect different historical circumstances. Early in the century, the German banking system used few checks (people preferred cash) and encouraged high levels of capital. Consequently, bank runs were rare, and the Reichsbank played little role in bank regulation. When a major banking crisis did occur in the 1930s, the monetary authorities had insufficient resources to save the banking system, which forced the government to intervene more directly.

English-style banking systems were more prone to bank runs. In response, the clearinghouse emerged, an organization that cleared checks, supervised banks, and at times issued its own currency. Central banks in these countries were modeled quite explicitly on clearinghouses and naturally took on the responsibility of bank rescues, whether as a lender of last resort or as a coordinator of bank consortia.[3]

■ Combination vs. Separation: The Economic Debate

A geopolitical description may serve to classify central banks, but it ignores the larger issue: *Should* a central bank undertake both monetary policy and bank supervision?[4] Just as different corporations reengineer in different ways, the "right" answer often depends on prevailing conditions — the financial system, the political environment, and the preferences of the public.

Central bank structure influences both monetary policy and bank supervision. Since the physical production of the two activities is largely unrelated (unlike, say, the production of cars and trucks), the economics of combination is the economics of information and incentives.

Monetary Policy

The most common criticism of combining monetary policy and bank supervision is that it can create a conflict of interest. Giving a central bank supervisory powers could make it reluctant to raise interest rates and stem inflation whenever such actions would hurt the banks. The central bank might view its primary function as protecting banks, not the public interest. The banking industry, which is better organized and more directly affected than the public, could "capture" the central bank and gain undue influence.

Regulatory capture has other sources besides overt political pressure. Voters, politicians, and oversight committees might view bank failures as evidence of poor supervision and hence low supervisory skill. If so, making banks look bad could make bank supervisors look bad. The central bank, conscious of its reputation, might then refrain from monetary policy that would stress certain banks or lower the industry's profits. Again, monetary policy would suffer.

Countries that are very concerned with the independence and credibility of their central banks may opt for separation, even of an extreme variety. Estonia isolated its monetary policy from bank supervision by establishing a currency board, a move that effectively cut off discretionary monetary policy of all sorts.[5] In the long run, the more stable and disciplined policy that arises from this kind of separation might benefit the banks as well.

Defenders of combination do more than deny this conflict of interest: They reverse it. In their view, separation leads the central bank to neglect a legitimate concern—the impact of monetary policy on the health of the banking system. The central bank might misjudge the effect of policy on the nation's banks, and perhaps thereby on the entire economy. This tendency could snowball as central bankers lose the knowledge and experience that come with supervisory responsibilities. Given the grave consequences of financial panic, collapse, or simple ill-health of the banking system, it is imperative that monetary policy consider these effects.

Historically, a concern for banks has not necessarily generated poor monetary policy. In the United States, the combined function has not prevented the Federal Reserve from tightening interest rates even when banks might be adversely affected.[6] Another good example is post-communist Poland, where a concern for banks was responsible for significantly *improving* monetary policy. As it became apparent in the late 1980s that monetary rules were driving money out of Polish banks and into foreign currency, drying up lending, the government undertook a series of successful monetary reforms.[7]

Combination is particularly needed, proponents argue, in times of financial crises, when only direct supervision can deliver the essential information on time.[8] The informal, "inside" information on how managers react and what strategies they pursue—the "feel" of an operation—simply cannot be duplicated by reading reports or consulting with other agencies. Supervisory powers also give the central bank additional leverage, which can be useful in forging a consensus for unified action.[9]

Supporters of separation disagree. They argue that documents and consultations provide sufficient information, and that, if anything, the close connections that develop between bankers and their regulators under a combined system can again lead to a conflict of interest, giving banks priority over taxpayers. The Anglo–German division regarding appropriate powers may reflect this difference. A German-style central bank, with little responsibility for rescuing banks, may have less need for information. Indeed, the Bundesbank and the FBSO rely on reports from independent auditors.

Separation has its own claim to producing the most information: Separate agencies with differing agendas will each search for evidence supporting their own position, whereas a combined agency might not.[10] For a simple explanation of this reasoning, consider only three pol-

TABLE 1 MONETARY POLICY AND BANK SUPERVISORY AGENCIES

Country	Monetary Policy Agency	Bank Supervisory Agency	Status
Australia	Reserve Bank of Australia	Reserve Bank of Australia	Combined
Austria	National Bank of Austria	Ministry of Finance	Separated
Belgium	National Bank of Belgium	Banking and Finance Commission	Separated
Canada	Bank of Canada	Office of the Superintendent of Financial Institutions	Separated
Denmark	Danmarks Nationalbank	Finance Inspectorate	Separated
Finland	Bank of Finland	Bank Inspectorate, Bank of Finland	Separated
France	Banque de France	Banque de France, Commission Bancaire	Combined
Germany	Deutsche Bundesbank	Federal Banking Supervisory Office	Separated
Greece	Bank of Greece	Bank of Greece	Combined
Hong Kong	Hong Kong Monetary Authority	Hong Kong Monetary Authority	Combined
Ireland	Central Bank of Ireland	Central Bank of Ireland	Combined
Italy	Banca d'Italia	Banca d'Italia	Combined
Japan	Bank of Japan	Ministry of Finance, Bank of Japan	Separated
Luxembourg	Luxembourg Monetary Institute	Luxembourg Monetary Institute	Combined
Mexico	Banco de Mexico	National Banking and Securities Commission	Separated
Netherlands	De Nederlandsche Bank	De Nederlandsche Bank	Combined
New Zealand	Reserve Bank of New Zealand	Reserve Bank of New Zealand	Combined
Norway	Norges Bank	Banking, Insurance and Securities Commission	Separated
Portugal	Banco de Portugal	Banco de Portugal	Combined
Spain	Banco de España	Banco de España	Combined
Sweden	Sveriges Riksbank	Swedish Financial Supervisory Authority	Separated
Switzerland	Swiss National Bank	Federal Banking Commission	Separated
United Kingdom	Bank of England	Bank of England	Combined
United States	Federal Reserve System	Federal Reserve System, OCC, FDIC, State governments	Combined

SOURCE: Adapted from Charles Goodhart and Dirk Schoenmaker, "Should the Functions of Monetary Policy and Banking Supervision Be Separated?" (footnote 14).

icy options—one favorable to banks (lower interest rates), one favorable to savers (higher interest rates), and the status quo (keeping rates the same). A combined, unbiased central bank may find evidence favoring either higher or lower rates, or it may find nothing at all. If it finds evidence supporting both policies, the information cancels out, and the monetary authority has expended much effort to justify no change in policy. If it finds evidence favoring one policy, it may stop searching because any new information could contradict the existing evidence, rendering useless the time, effort, and expense.

In a separated system, the supervisory branch will make the case for lower rates and the monetary branch will push for higher rates, with both using formal and informal channels to set forth their views. This is the theory behind the adversarial legal system—that contending sides produce the most information. Proponents of separation believe that in relatively stable economies, where policymakers' concern is justifiably less with crises and more with understanding the market, this argument can be decisive.

Not all concerns are purely informational, however. In Mexico, an undeveloped financial sector has meant, until very recently, that effective monetary control relied on direct bank controls, such as interest rate ceilings and credit limitations.[11] In such cases, the monetary authority may need to supervise the banks until the financial system develops further. The Banco de Mexico has a representative on the National Banking and Securities Commission, the independent body that regulates the nation's banks.[12]

Bank Supervision

Monetary policy is just one side of the coin. Central bank structure also influences bank supervision. Proponents of combination argue that banks which are regulated by the central bank can better withstand shifting monetary policy.[13] The central bank looks for vulnerable (as opposed to merely weak) commercial banks, aiming its supervisory practices more at identifying firms that will do poorly in stressful times than at firms that will do poorly in normal times.

This may be particularly necessary in developing countries, where the banking system is undergoing reform as well. Evidence from a recent study shows that countries that combined their supervisory and monetary functions had significantly fewer bank failures in the 1980s and early 1990s than did nations that chose separation.[14] Opponents, of course, chalk this up to the conflict of interest that results in an overly protective monetary policy.

The benefits of combination do not rest solely on what happens in stressful times. Combining bank supervision and monetary policy allows central bankers to consider the broader consequences of supervision. Federal Reserve Board Chairman Alan Greenspan put it aptly in testimony before the Senate Committee on Banking, Housing, and Urban Affairs:

Indeed, a single regulator with a narrow view of safety and soundness and with no responsibility for the macroeconomic implications of its decisions would inevitably have a long-term bias against risk-taking and innovation. It receives no plaudits for contributing to economic growth through facilitating prudent risk-taking, but it is severely criticized for too many bank failures. The incentives are clear.[15]

■ Central Bank Reputation

Another area of dispute—central bank reputation—is necessarily more vague and verges on the political. A central bank known for keeping prices stable looks and acts very differently from one perceived as soft on inflation. Commercial banks take fewer risks if they face a regulator known to play hardball. Reputation constitutes a key part of the corporate culture and determines how the public reacts to the central bank. It is an implicit contract shaping people's expectations.

Combining monetary policy and bank supervision can both help and hurt a central bank's reputation. Confusion may reign as the monetary authority's conflicting objectives make it harder for the public to sort through the organization's many responsibilities and judge its performance.[16] Does letting a bank fail mean that central bankers are incompetent, and therefore soft on inflation as well? Or does it mean that they are tough all around? Depending on the context, either interpretation makes sense. While combination may give a central bank strong incentives to establish a good reputation, exactly how to accomplish that may become less clear.

■ Conclusion

So many "on the one hand" and "on the other hand" arguments bring to mind Harry Truman's wish for a one-handed economist. Yet the diversity and success of actual practice around the globe belie the existence of any simple answer to the combination/separation question.

This does not mean that the arguments don't matter. They do. But different conditions imply different choices. Local conditions and preferences (the state of financial development or the degree of central bank independence, for example) make particular advantages and disadvantages more compelling. Creating a monetary authority free from bankers' influence may mean restricting the information available to it —in some situations a wise choice, but certainly one that should be made with open eyes.

Global diversity may arise for another reason as well. Combination and separation are more like two poles of a continuum than two discrete boxes. Many countries mix the two systems in an attempt to gain the advantages of both. Thus, the split between multiple regulators in the United States, the data collection activities of the Bundesbank, and the alternating inspections by the Bank of Japan represent strategies aimed at grasping both horns of the dilemma and producing a superior system.

As technology, finance, and the global economy change, so too may the shape of the world's central banks. In the United States, broader powers for commercial banks may mean that bank regulation will begin to overlap with securities regulation. New electronic payments vehicles—offered by banks and nonbanks alike—will create new problems for monetary policy. This should serve as a reminder that the regulatory structure keeps evolving and needs continuous reappraisal. Deposit insurance took 50 years to show its flaws. Perhaps a reasoned assessment of bank supervision will prevent a similar debacle.

Footnotes

1. See Herman E. Krooss, *Documentary History of Banking and Currency in the United States,* vol. 4. New York: Chelsea House Publishers, 1983, p. 1.

2. See General Accounting Office, "Bank Regulatory Structure: The Federal Republic of Germany," GAO/GGD–94–134BR, May 1994; and "Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure," GAO/GGD–97–23, November 1996.

3. See Herman E. Krooss, *Documentary History of Banking and Currency in the United States,* vol. 3 (footnote 1), p. 364.

4. I put aside political arguments as potentially important but outside the scope of this article.

5. See Owen F. Humpage and Jean M. McIntire, "An Introduction to Currency Boards," Federal Reserve Bank of Cleveland, *Economic Review,* vol. 31, no. 2 (1995 Quarter 2), pp. 2–11.

6. For a different view, see Thomas F. Cargill, "Central Bank Independence and Regulatory Responsibilities: The Bank of Japan and the Federal Reserve," Salomon Brothers Center for the Study of Financial Institutions, Monograph Series in Finance and Economics No. 1989-2, 1989, section X.

7. See International Monetary Fund, "The Adoption of Indirect Instruments of Monetary Policy," IMF Occasional Paper No. 126, June 1995.

8. For one statement of this view, see Richard F. Syron, "The Fed Must Continue to Supervise Banks," Federal Reserve Bank of Boston, *New England Economic Review,* January/February 1994, pp. 3–8.

9. The Federal Reserve Board of Governors refers to this as "the clout that comes with supervision." See "The Views of the Board of Governors of the Federal Reserve on the Consolidation of Bank Supervision and Regulation," Banking Industry Regulatory Consolidation Hearings before the Committee on Banking, Housing, and Urban Affairs. U.S. Senate, S. Hrg. 103–692, 1994, pp. 132–56.

10. This argument is based on the analysis in Jean Tirole, "The Internal Organization of Government," *Oxford Economic Papers,* vol. 46, no. 1 (January 1994), pp. 1–29.

11. See International Monetary Fund, "The Adoption of Indirect Instruments of Monetary Policy" (footnote 7).

12. The Mexican central bank has somewhat more power over payments activities. For details, see General Accounting Office, "Mexico's Financial Crisis: Origins, Awareness, Assistance, and Initial Efforts to Recover," GAO/GGD–96–56, February 1996; and Banco de Mexico, *The Mexican Economy 1994,* Planta Baja, Mexico, May 1994 (especially chapter 6).

13. See Bernard Shull, "How Should Bank Regulatory Agencies Be Organized?" *Contemporary Policy Issues,* vol. 11, no. 1 (January 1993), pp. 99–107.

14. See Charles Goodhart and Dirk Schoenmaker, "Should the Functions of Monetary Policy and Banking Supervision Be Separated?" *Oxford Economic Papers,* vol. 47, no. 4 (October 1995), pp. 539–60.

15. Alan Greenspan, testimony given at the Banking Industry Regulatory Consolidation Hearings before the Committee on Banking, Housing, and Urban Affairs (footnote 9), pp. 130–32.

16. See David M. Kreps, "Corporate Culture and Economic Theory," in James E. Alt and Kenneth A. Shepsle, eds., *Perspectives on Positive Political Economy,* New York: Cambridge University Press, 1990, pp. 90–143.

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