Journal of International Money and Finance 61 (2016) 101–119

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Macro prudential governance and central banks: Facts and drivers

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A R T I C L E I N F O

Article history:
Available online 14 November 2015

JEL Classification:
E58
E63
G18

Keywords:
Macro prudential supervision
Micro prudential supervision
Central bank independence
Monetary policy rules

A B S T R A C T

The Great Crisis has highlighted the importance of establishing macro prudential architectures to address problems of financial stability. Central banks are always part of macro prudential settings, but their role is far from being homogeneous across countries, reflecting the fact that according to economic theory there are pros and cons in extending central bank influence to macro prudential supervision. The issue is then genuinely empirical: are there any meaningful drivers explaining the actual choices made by policymakers about the central bank's role in macro prudential governance?

We identify three potential drivers – micro supervision involvement, monetary policy discretion, overall institutional independence – and test for their relevance, by analysing current institutional settings in 31 advanced and emerging market economies. We find that central bankers already in charge of micro supervision and less politically independent are more likely to get extended macro prudential powers; the same is true, if they have low monetary policy discretion, being constrained by a monetary stability objective. We interpret these results by using a political economy perspective.
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1. Introduction

The Great Crisis has highlighted the need for financial stability. Recent reforms of financial regulation across countries have been motivated by the fact that sole attention to monetary stability and

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http://dx.doi.org/10.1016/j.jimonfin.2015.11.002
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micro supervision, i.e. the stability of individual institutions and markets, was not enough to guarantee the safeness and soundness of the financial industry. A broader approach, namely, macro prudential policy, i.e. the use of prudential tools to mitigate systemic risk,[1] was deemed to be necessary to ensure the resilience of the financial system as a whole. A macro prudential framework has to address the cross-sectional dimensions which characterize any systemic risk distribution, and consequently different authorities have to be involved in macro governance, including the central bank. In fact in each country the already existing overall micro supervisory architecture can imply the existence of different authorities – at least two – excluding the cases where the central bank is at the same time also the single supervisor. The reform of financial supervision and the establishment of macro prudential regimes has gone hand in hand with various degrees of involvement on the part of central banks. Invariably, central banks have been involved in macro prudential settings, but their role is far from homogeneous across countries.

A central bank can be lightly involved, when the mandate of financial stability is shared by multiple agencies, the central bank just being one of them; the opposite is true when the central bank is the sole reference of the macro prudential mandate. Intermediate settings – when a central bank is coordinator or leading authority among multiple agencies – can occur.

In 2010, the US Congress passed the Dodd–Frank Act. This law created the Financial Stability Oversight Council (FSOC), which includes the Fed as the authority responsible for identifying risks and responding to events that threaten financial stability. In the EU, the European Systemic Risk Board (ESRB) is a new agency, created in the autumn of 2009 with the responsibility for macro prudential policies, where the coordinating actor is the European Central Bank (ECB).

The building up of macro prudential architectures has also characterized single countries within the European Union. In Germany, policymakers passed the Act on Monitoring Financial Stability in 2013 and set up a new macro prudential authority, known as the Financial Stability Committee (FSC), which works in close relation with the Bundesbank. In the UK, a key factor of the latest regulatory reform was the creation of a macro prudential agency within the Bank of England, namely, the Financial Policy Committee (FPC).

How to explain the major role taken by central banks in new macro prudential architectures? To anticipate the results of the review of the literature, from a theoretical point of view, pros and cons are present in extending the central bank influence in macro prudential policies.

Therefore, policymakers have to address a series of possible trade-offs between the expected gains and costs in having the monetary authority as a more or less influential actor in designing macro prudential strategies. The natural question that arises is genuinely empirical: is it possible to identify common drivers explaining political choices concerning central bank involvement in macro prudential governance?

In this paper we implement an econometric cross-section analysis of the determinants of central bank involvement in macro prudential governance, testing for different assumptions suggested by the existing theoretical and institutional literature. Time series analysis, although interesting, would be difficult to implement because most of our variables, such as involvement in macro and micro supervision and monetary goals, are substantially constant, or at least slowly-changing. One more limitation is the short sample.

Our empirical results provide evidence that: (a) central banks acting as micro supervisors of banking industry are more likely to be given deeper macro prudential powers; (b) higher central bank political independence is associated with lower involvement in macro supervision; (c) central banks pursuing specific price stability objectives are more likely to be endowed with macro supervisory responsibilities. We interpret these results by using a political economy perspective.

The present article differs from the existing literature in two main aspects. First of all, while the interaction between the macro prudential and monetary policy has been largely studied – see recently Schoenmaker (2014) and Smets (2014), among others – to the best of our knowledge there is nothing about the drivers of governance arrangements, i.e. which are the factors that can concretely

[1] Following the definition of the International Monetary Fund, the focus is on the concept of systemic risk, i.e. the risk of disruptions to the provision of financial services caused by an impairment of all or parts of the financial system, which can have seriously negative consequences for the real economy.

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