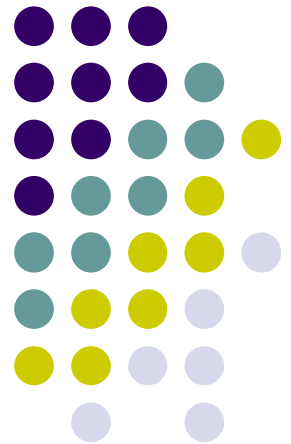
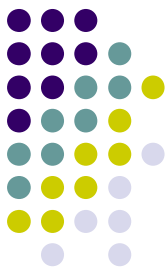


Monetary Policy and Bank Supervision

Presentation at ESRI Conference
“Japanese Monetary Policy:
Experience and Future”

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IR/PS, UCSD and NBER





Introduction

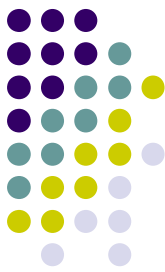
- In some countries, monetary authority supervises the banks
- In other countries, monetary policy and bank supervision are conducted by separate (and independent) entities
- What are pros and cons for alternative structures of monetary policy and bank supervision?
- What do we learn from the recent Japanese experience?

Does the bank supervisory framework matter?



- Barth, James R., Daniel E. Nolle, Triphon Phumiwasana and Glenn Yago (2003). “A Cross-Country Analysis of the Bank Supervisory Framework and Bank Performance,” *Financial Markets, Institutions & Instruments*, 12, 67-120.
 1. Single authority or multiple authorities?
 2. Should the central bank be a bank supervisor?
 3. Should bank supervisors supervise other financial service industries (scope of supervision)?
 4. Independence of supervisory authorities from political and economic policy pressure and influence

Empirical evidence by Barth et al. (2003)



- Examine cross-country correlations between the bank supervision framework and bank performance (Before tax profits / Assets)
- Find no clear correlation here
- Need to look at other performance measures
- Can we learn something from the Japanese experience?

Changes in the Japanese bank supervision



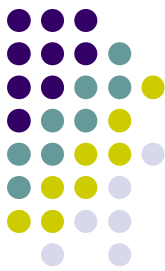
- Relevant for all four issues
 1. FSA (Financial Supervisory Agency initially, Financial Services Agency later) became the supervisory authority for all banks, including agricultural coops, shinkin banks and credit unions
 2. Bank of Japan, however, continued the bank examination and considered financial stability one of their goals after legal independence was given (1998)
 3. FSA supervises all banking, securities, and insurance industries
 4. FSA is independent of the Ministry of Finance. How about politics?

Issue that is most relevant for monetary policy



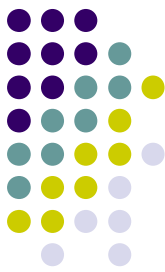
- #2. Bank of Japan retained its own bank examination function and felt responsible for bank supervision
- Japanese experience suggests potential problems of having the central bank involved in bank supervision
 - It also suggests potential problems of a lack of coordination between monetary authority and bank supervisory authority

Involvement of the central bank in bank supervision: general issues



- Central bank may have better information about the conditions of banks (also may have better human capital)
- Independence of central bank may be useful for bank supervision (on the other hand, involvement in bank supervision may make it harder to keep the independence)
- May pursue too loose monetary policy to avoid banking problems
- Failure in bank supervision may adversely affect the central bank's reputation

What do we learn from the Japanese experience?



- Too loose monetary policy does not seem to have been a problem
- Rather, the BOJ may have chosen too tight monetary policy to encourage the restructuring of the banking industry
- Health of the financial system is one of the goal of the BOJ, but the BOJ does not have tools of bank supervision (other than the BOJ inspection of banks)
- This may have distorted the monetary policy making

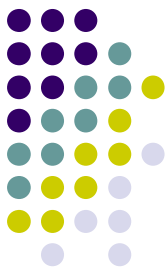
BOJ's view on monetary policy and structural reforms



In order to bring Japanese economy back to a solid recovery path, it is important not only to provide support from monetary and fiscal sides but also to steadily promote financial system revitalization and structural reforms.

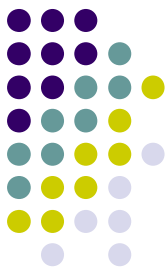
“Change of the Guideline for Money Market Operations,”
February 12, 1999

Zero interest rate policy and bank supervision



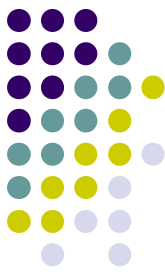
- Oct. 1998: Nationalization of LTCB
- Dec. 1998: Nationalization of NCB
- Feb. 1999: BOJ started ZIRP
- Apr.-Oct. 1999: Closures of Kokumin, Kofuku, Tokyo Sowa, Namihaya, and Niigata Chuo Banks
- Oct. 1999: Yanagisawa left the FRC, followed by four chairs in the next 14 months, only one of which perceived to be politically neutral
- Aug. 2000: BOJ lifted ZIRP
- Mar. 2001: Back to ZIRP (quantitative easing)
- Feb. 2002: Further quantitative easing simultaneously with government announcement to accelerate structural reforms

Zero interest rate policy and bank supervision



- Monetary policy seems to have reacted to the changes in the bank supervisory policy
- Did the (too much?) focus on the structural reforms by the BOJ impair the monetary policy decision?
- Lack of coordination between the BOJ and the FSA may have been the problem
- Attempts of coordination after February 2002 and October 2002 (Takenaka became the head of the FSA)

February 2002 announcement



To realize the full permeation of the effects of strong monetary easing, it is essential to strengthen a financial system and ensure its stability by making a swift move to resolve the non-performing loan problem. It is also vital to make progress in structural reform on the economic and industrial fronts through tax reform, streamlining of public financial institutions, and deregulation. The Bank strongly hopes that both the Government and the private sector, in particular financial institutions, will take more determined and effective steps in this regard. (“On Today’s Decision at the Monetary Policy Meeting,” February 28, 2002)

October 2002 announcement



In order to ensure the abundant liquidity provision by the Bank leading to the revitalization of the economy, improvement in credit allocation function of capital markets is important in addition to the strengthening of the financial intermediary function of banks. In this regard, the Bank will closely monitor the impact of expected government measures to accelerate the resolution of the NPL problem on corporate financing and explore possible measures to secure the smooth working of corporate financing. (“Change in the Guideline for Money Market Operations,” October 30, 2002)

Lack of coordination between economic policy authorities



- Nordhaus (1994) modeled lack of coordination between the monetary authority and the fiscal authority (who likes to have more budget deficit than the monetary authority)
- William Nordhaus (1994). “Policy Games: Coordination and Independence in Monetary and Fiscal Policies,” *Brookings Papers on Economic Activity* 2, 139-216.
- In Nash equilibrium, the interest rate is higher and the budget deficit is higher than the levels either authority considers optimal
- Monetary authority does not want to cut the interest rate, because it does not expect the fiscal authority to cut the budget deficit

Game between the central bank and the bank supervisor



Central Bank's preference: $V_M = -\frac{1}{2}(x - x_M^*)^2 - \frac{b}{2}(u^* - u)^2$

Bank Supervisor's preference: $V_S = -\frac{1}{2}(x - x_S^*)^2 - \frac{b}{2}(u^* - u)^2 - \frac{a}{2}s^2$

Structural reforms: $x = s - \mathbf{p}$

Phillips curve: $u = u^* + e \cdot x - f \cdot \mathbf{p}$

x : extent of structural reforms

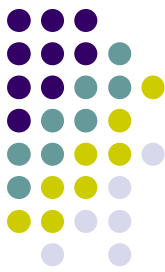
u : unemployment rate (macroeconomic condition)

s : supervision effort (bank supervisor's choice)

\mathbf{p} : inflation rate (central bank's choice)

Assume $x_M^* > x_S^*$

Bliss points of the policy makers



Central Bank's bliss points:

$$\mathbf{p}_M = \frac{e}{f} x_M^* \quad s_M = \frac{e+f}{f} x_M^*$$

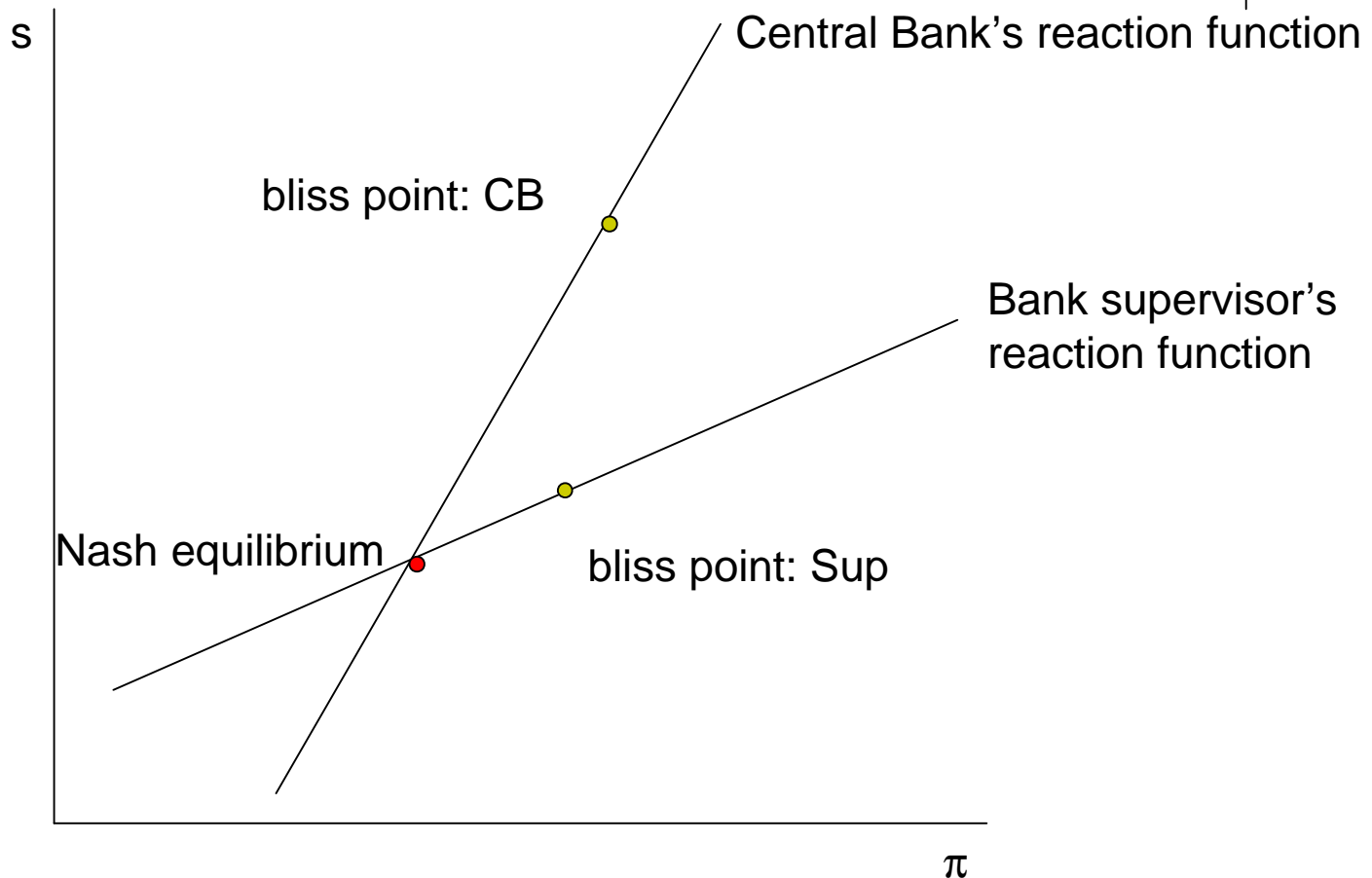
Bank Supervisor's bliss points:

$$\mathbf{p}_S = \frac{bfe - a}{bf^2 + a[1 + b(f + e)^2]} x_S^* \quad s_S = \frac{bf(e + f)}{bf^2 + a[1 + b(f + e)^2]} x_S^*$$

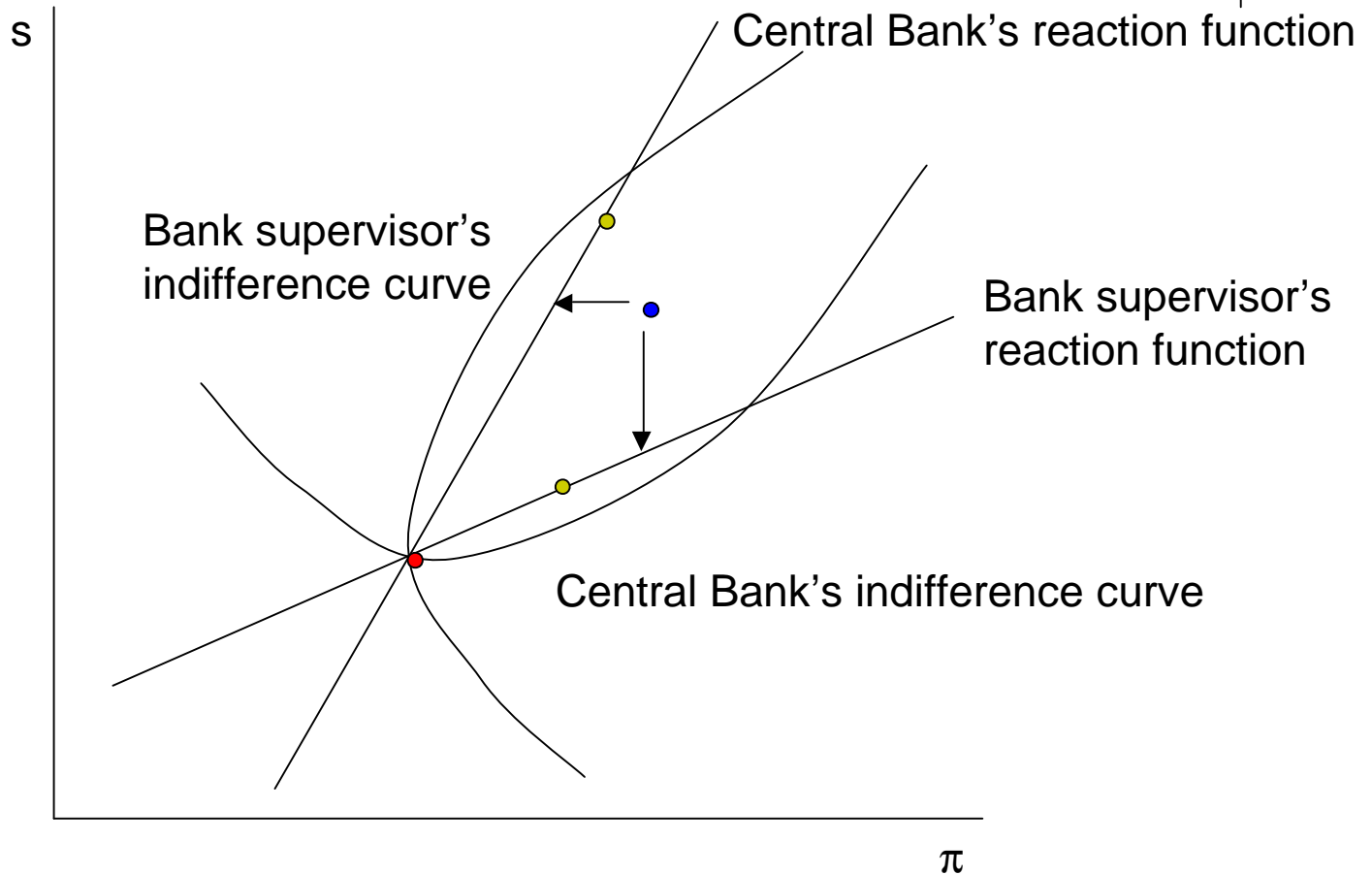
One can show:

$$\mathbf{p}_S < \mathbf{p}_M \quad s_S < s_M$$

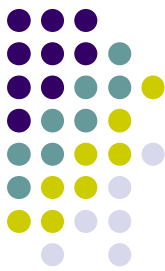
Non-cooperative equilibrium and gains from cooperation



Non-cooperative equilibrium and gains from cooperation



Conclusion



- Japanese situation (at least between 1998 and 2002) suggests a problem of lack of coordination between monetary authority and bank supervisor
- Nordhaus type of model can capture the story well
- Monetary authority who pays too much attention to bank supervision may choose too tight monetary policy
- Importance of coordination between the central bank and the bank supervisor