1. Introduction

In recent years, a reform of the supervision authorities has been under discussion in every European country. The basic issue is whether it is appropriate for the central bank, already in charge of monetary policy[1], to be made responsible for supervision[2] as well. In some countries banking regulation is carried out by the central bank, in others it is the duty of different authorities, possibly in collaboration with the central bank, or lastly it is the task of a single authority separate from the central bank. Among the European countries, the latter is true of the United Kingdom[3], Austria[4], Belgium, Denmark, Germany, Sweden[5], Hungary[6], Malta, Estonia and Latvia. On a world level, of Japan and South Korea. Ireland on the other hand is an anomaly. The only authority responsible for bank supervision there is the central bank[7]. What is therefore emerging are two models: one with a single authority and the other with multiple authorities[8].

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[1] On the factors determining the decision to delegate responsibility for monetary policy to the central bank, a valid answer is given by Alesina - Tabellini (2003).

[2] According to Lannoo(1999), the rethinking of the job of banking supervision can be explained with the growing development of banks and the loss of clarity about the services offered.

[3] The FSA in the United Kingdom placed banking supervision outside the central bank, but since one of the functions of regulation is to protect from systemic risk, a close, transparent relationship needs to be established with the central bank and the Ministry of Finance. In 1997 a Memorandum of Understanding was signed between the FSA, the Treasury, and the Bank of England. This Memorandum explains how the three bodies work together to achieve financial stability. But "*The Authorities of the United Kingdom underline that models of regulation should reflect the structural and cultural characteristics of local financial services market. What is right for the United Kingdom, is not necessarily right for all*". **Sykes (FSA 2004)**

[4] Austria adopted the FMA single authority supervision model in 2002. This body carries out supervision on the banking, insurance, pension fund, and stock market, cooperating with the Austrian central bank.
Grunbichler – Darlap (FMA 2004)

[5] In Sweden the central bank (Riksbank) answers directly to Parliament and has no supervisory role. Its role is to promote a safe and efficient payment system and lender of last resort. Since 1971 supervision has been entrusted to a single authority (Finansinspektionen) which watches over the banking, stock and insurance markets with the purpose of achieving stability and efficiency in the financial system and defending the consumer.
Strom (FSA 2004)

[6] In Hungary the single financial authority was set up in April 2000, with responsibility for the whole financial sector. Decisions taken by the supervising body are final. Appeals can only be made through the courts of justice. Even before the institution of the single authority, the Hungarian central bank never had a banking supervision role.
Balogh (FSA 2004)

[7] Holland is moving in the same direction.
Assigning the role of prudential supervision to the central bank involves advantages and disadvantages. Among the pros, we find systemic stability, stability in the system of payments, cost efficiency, good central bank reputation, which can however become a disadvantage if the reputation is bad. There may be other disadvantages in terms of price stability, monetary policy dictated by the banks, over-concentration of power in the hands of the central bank.
Prast – Lelyveld (De Nederlandsche Bank 2004)

[8] In a recent work Masciandaro (2005) uses an empirical model to analyse the possible factors determining the process of reunification in the various European countries.
For an examination of the pros and cons of attributing the responsibility for monetary policy and supervision to the central bank, cfr. Peek – Rosengren – Tootell (1999, 2001, 2003); Masciandaro (1993), Eijffinger (2001) and for further

The policymaker, whose main aim is to be re-elected, is the one who decides the institutional setup[9]. The political economy choices will be, therefore, influenced by the wish to get the favour of the electors. Theoretical analysis[10] suggests that the politician prefers an expansive monetary policy before the elections and a tight monetary policy, to low inflation, in the post electoral period. The possibility for the government to handle monetary policy depends on institutional design, chosen in every country. Independent central banks or dependent central banks with more conservative central banker limit the possibility for the policymaker to carry out twisted political economics[11]. Such setup is not therefore desirable for a politician in the pre-electoral period, especially in that countries characterized by an higher rate of unemployment. The hypothesis is correct if there is agreement, inside the same political class, on the monetary policy choices[12]. How is it possible now to connect the different politician's setup choice, according to the period he is in, with the possibility that the responsibility of supervision policy is entrusted to central banker by the same policymaker? In fact the possibility that the central banker is able or less to have the assignment to pursue the financial stability complicates the picture. From the point of view of the policymaker, the conduct of supervision policy, has some implications in terms of cost-benefits analysis. We can think that in general the politician prefers, especially in electoral period, attitudes of financial accommodation from the supervisor. He should carry out a policy to avoid bankruptcies, because it is politically more advantageous (you think about the diffused benefits for depositors and to the specific advantages for banking and bankers). This, however, does not mean that it is always politically convenient that the central bank has the powers both of monetary policy and of supervision. In fact, if the central banker is inclinable to an accommodating monetary policy, to

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depth Padoa – Schioppa (1999), among those in favour. Arguments in favour of separation are reported in Goodhart - Shoenmarker (1995); Eijffinger – De Haan (1996); Di Noia – Di Giorgio (1999).

[9] The first studies on the electoral cycle are those of Nordhaus (1975), Hibbs (1977), then they were taken back by Alesina (1987), Alesina - Sachs (1988).

[10] See Kydland - Prescott(1977) and Barro - Gordon (1983a,b) for models on the economic political cycle with rational expectations (time inconsistency).

[11] There are a lot of theoretical studies and empirical analysis in literature on the relationship between different degrees of central bank independence and inflation's performance and other macroeconomics variables. For the first one see Rogoff (1985), Lohmann (1992), Walsh (1995), Persson - Tabellini (1997). For the second one see: Bade- Parkin (1985), Alesina (1989), Grilli - Masciandaro- Tabellini (1991), Cukierman (1992), Alesina - Summers (1993).

[12] Eijffinger - Hoeberichts (1996), Bernhard (1998).

possess the powers of supervision would mean to be able to develop easier a laxist monetary policy; and this serves the interest of the politician. Otherwise, if the central banker is conservative, he would pay attention to his not accommodating reputation. In this case, he would like to strengthen such reputation, with the same behaviour, also when he carries out the supervision policy.

The present paper intends to analyze theoretically this problem list[13].

The paper is structured as follows: after the introduction, in the second section we present the general model. In the third and fourth sections we examine the principal-and-two-agents model in the electoral and non-electoral periods. In the fifth and seventh sections the single-agent contract is analysed, in the electoral and non-electoral periods. The sixth and eighth sections give a comparison between the two contracts. In the ninth section remarks and possible developments are discussed. Finally, our conclusions.

2. The general model

This paper[14] analyses the advantage to be gained in entrusting the tasks of "banking supervision" and "monetary policy" to two agents, Banking Authority (BA) and Central Bank (CB), or to a single agent, CB. In this analysis two periods are examined: electoral and non-electoral. The model is that of a principal with two agents, where the principal is the political group in power, while the agents are, as we have said, BA and CB.

The politician has his own utility function U, which will take on four different values according to whether four different events take place. These events are:

Bs = stability in the banking system

Ps = price stability

–Bs = banking instability

–Ps = price instability.

The utility function U is defined thus:

[13] In the literature there are no theoretical models linking the problem of the choice of institutional setup of supervisory bodies, with the electoral cycle.

[14] The approach adopted is that proposed by Franck - Krausz (2004)