

consistent proxies of the reputation endowment effect and bureaucracy effect respectively. In section six, an econometric analysis is performed. Section seven puts forward some conclusions as well as perspectives for further research.

2. Explaining the Financial Supervision Regime: A Path Dependence Approach

Goodhart (2004) wondered if the development of financial supervision architecture is designed or accidental. It has been argued regularly and frequently that the design of supervision is essentially reactive, lagging behind innovation and evolving risks, and that the reasons for supervisory reforms are largely political. We claim that the evolution of financial supervision is not accidental. To justify this, we investigate the determinants that should lead a country to reform or to maintain the supervisory regime, with particular attention to the role of the central bank.

Our basis is that in each point of time, gains and losses of a supervisory model are expected variables, calculated by the policymakers that maintain or reform the supervisory regime. But the expectations of policymakers are likely to be influenced by structural economic and institutional variables, which may vary from country to country. Therefore, given the national economic and institutional endowment, these variables can determine, *ceteris paribus*, the policymaker's expected gains or losses of a specific supervisory regime. The supervisory regime can become the dependent variable in a *path dependence* framework. Furthermore, economic agents do not have perfect information on the true preferences of the policymaker: his/her optimal degree of supervision unification is a hidden variable.

The crucial issue is the identification of the policymaker's preferences. In the economic literature, there is lack of theoretical studies that consider the policymaker's objective function for the financial supervisory design. The first approach to identify the policymaker's

utility function could be the so-called narrative approach, in which official documents are interpreted to gauge the policymaker's choices. The narrative approach has been extensively used in the monetary policy literature: see Potts and Lockett (1978), Wallace and Warner (1985), Hakes (1988 and 1990), Romer and Romer (1989). This approach has the drawback that there is substantial room for differences between the policymaker's announcements and his/her true preferences.

The approach we intend to follow here is to consider the policymaker's actual choices in determining the level of financial supervision unification (factual approach). In each random point of time, we observe the policymaker's decision to maintain or reform the financial supervision architecture, choosing the level of unification. In other words we consider policymakers faced with discrete choices.

Building an empirical analysis consistent with this discrete choice process in a cross-country perspective involves claiming the existence of unobservable policymaker's utilities U_{ij} , where each U_{ij} is the utility received by the i th national policymaker from the j th level of financial unification. Since the utility U_{ij} is unobservable, we represent it as a random quantity, assuming that it is composed of a systematic part U and an random error term ε .

Furthermore, we claim that the utilities U_{ij} are a function of the attributes of the alternative institutional level of financial unification and of the structural characteristics of the policymaker's country.

Combining the two hypotheses, we have a random utility framework for the unobservable financial unification variable. As usual, we assume that the errors ε_{ij} are independent for each national policymaker and institutional alternative, as well as normally distributed. The independence assumption implies that the utility derived by one national policymaker is not related to the utility derived by any other national policymaker, and that the utility that a

policymaker derives from the choice of a given level of financial consolidation is not related to the utility provided by the other alternative. In the factual approach the first crucial issue is the measurement of the policymaker's choices, that is the definition of the dependent variable.

3. Financial Supervision Unification and Central Bank Involvement

The first problem when considering financial supervision concentration as a dependent variable, is to construct this variable. How can the degree of concentration of financial supervision powers be measured? To this end we use the financial authorities concentration index (FAC Index, Table 1B) proposed in Masciandaro (2004)². The index has the maximum score (7) in countries where all the supervision responsibilities are in the hands of a single agency, this can be a new financial services authority – as in the UK or Germany – or the central bank – as in Ireland. Symmetrically, the index takes the minimum score (1) in countries with highly fragmented supervisory regimes – as in the US or France.

But we should also consider the nature of the institutions involved in supervisory responsibilities, focusing on the distinction between the central bank and any other form of institution at least for two reasons.

First of all, any supervisory regime will have to provide a link between supervision and the central bank, given the potential relationship between monetary stability and financial stability. It has been pointed out correctly (Llewellyn 2005) that, irrespective of its role, the central bank is the ultimate authority for the systemic stability of the payment system. Thus, among the authorities that can have supervisory responsibility, the central bank has a special nature being the institution responsible for monetary policy. Furthermore, the special

² The construction of the index is described in Appendix 8.1.