# 2

# Banking in the Economy—Why Banks Warrant Special Attention

The legal definitions of banking, and the permitted activities of banks, vary across countries. Nevertheless, the essential characteristics of banks are the same. They issue liquid, nominally valued liabilities, many of which are payable on demand at par, and they mainly acquire assets that are illiquid, relatively difficult to value, and of longer maturity than their liabilities.[2]

While the role of banking in the economy is declining in some industrial countries, banks continue to dominate the financial systems of most developing and transition countries. A sound banking system is important because of the key roles it plays in the economy: intermediation, maturity transformation, facilitating payments flows, credit allocation, and maintaining financial discipline among borrowers. Banks provide important positive externalities as gatherers of savings, allocators of resources, and providers of liquidity and payments services. In transition and developing economies with less well-developed financial markets, banks typically are the only institutions producing the information necessary for intermediation, providing the portfolio diversification required for maturity transformation and risk reduction, and helping monitor corporate governance. Even in economies with highly developed financial markets, banks remain at the center of economic and financial activity and stand apart from other institutions as primary providers of payments services and as a fulcrum for monetary policy implementation.

Banks are particularly subject to market failures arising from asymmetries of information. On the asset side, they take on the risk of valuing projects and funding borrowers whose ability to repay is uncertain. On the liability side, the confidence of creditors and depositors who have imper-

[2] See Diamond and Dybvig (1983), Fama (1985), and Christopher James (1987).

fect information on the bank's actual position is essential to a bank's ability to provide deposit and payments services. High leverage and the illiquidity and intransparency of bank assets render banks particularly vulnerable to losses of creditor confidence. Because of sequential servicing (where the first in line is served first), depositors and other creditors have an incentive to run when confidence is lost.[3]

The vulnerability of banks leads to public policy concerns because of the negative externalities related to bank failures. These negative externalities occur when bank failures spill over to harm other banks and economic agents. Contagious runs and attendant domino effects and payments system disruptions are the main negative externalities associated with bank fragility. Runs to quality, that is, from unsound banks to safer havens, may be rational but can disrupt the financial system. When, because of deficient information, depositors cannot distinguish sound banks from unsound banks, they may precipitate unjustified runs against sound banks, which could cause a systemic crisis.[4] The evidence on the actual susceptibility of banks to contagion is mixed, and research has focused on only a few countries. For example, Pozdena (1991) provides evidence of spillovers at U.S. banks, but Kaufman (1994) argues that a wealth of evidence for the United States shows that depositors have been able to distinguish sound banks from unsound ones.

In addition to worries over the potential for contagion, public policy concern is often justified on the grounds that banks provide public goods. Banking services do not fit the definition of a pure public good—one where consumption by one person does not diminish the supply available to another (often referred to as "nonrivalry in consumption," see Sandmo, 1987). Nevertheless some bank services, such as the mobilization of financial resources and the provision of payments services, do have quasi-public good properties.

Both the potential negative externalities in banking due to depositor runs and the public good aspects of banking deriving from savings mobilization and payments services are linked to the traditional banking business of taking demand deposits and making loans. Moreover, it is the juxtaposition of par-valued deposits with opaque and illiquid loans that gives rise to many of the most significant difficulties in maintaining soundness in both universal banks and commercial banks operating with a more limited scope. However, banks in many countries engage in a broad range of activities. For example, they provide a wide variety of financial services

[3] Diamond and Dybvig (1983) discuss banks' vulnerability to runs.

[4] Sundararajan and Baliño (1991, p. 3) define a financial crisis as, "a situation in which a significant group of financial institutions have liabilities exceeding the market value of their assets, leading to runs and other portfolio shifts, collapse of some financial firms, and government intervention."

and trade and invest for their own accounts, as well as for clients. Even though these activities add to the risks that banks undertake, draw a new set of clients into contact with the banking system, and provide new avenues through which the core obligations to depositors may be jeopardized, they do little to alter the public policy concerns surrounding the functioning of the banking system.[5]

Regardless of the extent of bank involvement in broader financial services and investment activities, the banking system plays a central role in the economy. Therefore, virtually no government will permit widespread bank failures or forbear from intervening to support depositors in the event of systemic bank insolvencies. Such public involvement has political as well as economic determinants. The difference in treatment of banks compared with other types of enterprises—typically reflected in lender-of-last-resort accommodation of banks and explicit and implicit guarantees of bank liabilities by governments—has implications for the design of macroeconomic and prudential policies. The impact of macroeconomic conditions on the banking system requires special attention for two reasons: first, a well-functioning banking system is important for the effectiveness of macroeconomic policies, and second, weaknesses that emerge in the banking system, if left unattended, could pose a threat to macroeconomic stability.

Public policy concerns with banking soundness should be focused on the banking system as a whole, rather than on individual banks. Only when the deterioration of a particular bank has systemic implications due to possible contagion or domino effects, or when the bank represents a large portion of the banking system, would the consequent damage to the system as a whole warrant public policy attention. Prevention of stress in a banking system requires well-balanced institutional and regulatory structures, as well as a macroeconomic policy mix that is sensitive to banks' financial soundness.

[5] Nor does involvement in such activities diminish the importance of the framework for sound banking, which includes both internal and external governance, as is discussed in Chapter 3.