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The Banking System and Macroeconomic Policy Flexibility

An unsound banking system affects macroeconomic policy formulation across sectors. Monetary and exchange policies are likely to be constrained, as monetary instruments become less effective and their ability to support an exchange rate is diminished. A tightening of monetary policy may be insufficiently effective or cause serious distortions; it could even trigger a crisis and force a reversal of policy stance. Although the reduced effectiveness of monetary policy could be offset to some extent by fiscal tightening, banking sector problems could themselves result in increased budgetary commitments. These consequences of unsoundness, along with the impact on the real sector of prolonged banking system deficiencies, imply that actions to strengthen the soundness of the banking system or to prevent any deterioration should receive high priority in the design of macroeconomic policies.

The degree of unsoundness at which these effects take hold will vary from situation to situation. A banking system can become increasingly unsound and yet continue to function for an extended period of time without a crisis. In cases where confidence is more fragile, such as in many emerging market economies, a small degree of unsoundness could have strong consequences in the form of deposit runs and capital outflows.

Over the long term, structural elements are critical to building a strong banking system. Such a system must be composed of individually sound banks operating in a supportive institutional and economic environment, controlled by a combination of internal governance, market discipline, and official regulation and supervision. These structural policies could themselves affect macroeconomic outcomes, a factor that must be taken into account in the design of prudential regulations. As important as the institutional setting and control mechanisms are, however, over shorter time frames, the soundness of the banking system will be affected most sharply by the economic environment.

In some cases, particularly when bank unsoundness is associated with the business cycle, support of the banking system may not present a conflict with overall macroeconomic objectives. Loose monetary policy was probably appropriate in Thailand in 1986–87, so support of the banking system did not hinder the pursuit of macroeconomic policy goals.[124] The same might be said of Japan in 1994–95 and the United States in 1990–91. Happy coincidence should not be confused, however, with the real ability to freely choose and conduct policy. In most instances, particularly in developing and transition economies, an unsound banking system coincides with macroeconomic imbalances that require stringent financial policies. These may be inconsistent with direct support of the banking system and may in fact exacerbate bank unsoundness.

This presents policymakers with difficult challenges. A sound banking sector is itself a necessary objective of macroeconomic policy. Banking is universally treated as a special economic activity. Given governments' propensity to support banking sectors that become unsound, it would appear shortsighted to implement macroeconomic policies that could weaken the banking sector. The externalities relating to bank soundness, and the interlinkages between a sound banking system and macroeconomic developments and policies, argue for adequately considering the soundness of the banking system in formulating macroeconomic policies and the policy instrument mix. When the authorities are forced, however, to make the stability of an unsound banking system their chief concern, policy flexibility is lost. Therefore, in addition to taking account of the current state of the banking system in macroeconomic policy formulation, microeconomic policies should be designed so that the banking sector is robust enough to withstand macroeconomic adjustments when they become necessary.

[124] Johnston (1991).