Role of Banks in Saving the Economy

Why in news?

At a time when the World Bank and the International Monetary Fund have warned of a possible global recession in 2023, the 2022 Nobel Economics Prize has shed light on the role of banks in saving the economy.

Who has won the Nobel Prize for Economics in 2022?

- The Nobel Prize in economics 2022 has been given to US economists
    1. Ben S. Bernanke
    2. Douglas Diamond
    3. Philip H. Dybvig
- **Reason**- For research on banks and financial crises

- **Bernanke's work**- Bernanake's research highlighted the volatile relationship between the working of bank and the roll-out of money into the economy.
- Through statistical analysis and historical source research, Bernanke demonstrated how failing banks played a decisive role in the global depression of the 1930s.
- It highlighted how failure of banks can aggravate a conventional economic crisis.
- **Causes of the Great Depression-** According to the Keynesian explanation, the reasons for the Great depression are
    1. inadequate investment and consumption expenditure
    2. the animal spirits of pessimism
- According to Bernanke, bank failures during this period sustained and aggravated the depressing conditions during 1929-1933.
- During this period, unemployment increased almost 25% and industrial production plummeted by close to 46%.
- **Criticisms**- There are mounting criticisms against Bernanke (Fed governor from 2002 to 2005) who ushered massive quantitative easing (QE) program.
- The critics blame Bernanke for slashing the interest rates and claim that he missed the warning signs of the subprime housing crisis.
- They also quote that this led to the creation of easy money bubble (Bernanke bubble) that has resulted in today's inflation, with consumer prices rising to a 40-year high.
- **Diamond and Dybvi's work**- Diamond and Dybvig worked together to develop theoretical models explaining
    1. Why banks exist?
    2. How their role in society makes them vulnerable to rumours about their impending collapse?
    3. How society can lessen this vulnerability?

- They argued that banks emerge as natural intermediaries that help ease liquidity.
- They highlighted how liquidity problem in a bank can lead to bank run which in turn can derail economic prosperity.
- They also discussed about the **central bank discount window** under the lender of last resort (LOLR) facility, which reduces the probability of bank runs.
- Diamond highlighted the delegated monitoring aspects of banks which benefit bank depositors by avoiding costly monitoring.

How are banks useful to the economy?

- Failure of banks has the potential to affect the medium-term prospects of economic prosperity.
- **Mobilisation of savings**- Banks play a critical role in mobilisation of savings and promotion of capital formation, which help in achieving and sustaining economic growth.
- **Addresses maturity mismatch**- The borrowers prefer longer term to maturity for their loans, while the savers require the option to immediately draw upon their savings.
- This conflict in preferences of the borrowers versus the savers is known as maturity mismatch.
- **Addresses size mismatch**- The loan amount sought by the borrowers are generally huge, whereas the savings of individuals is generally less.
- In the absence of banks, it is impossible for the borrower to approach a large number of savers with little acquaintances and pool the loan amount.
- **Conflict resolution**- Banks play a critical role in resolving the conflict, and provide options for both the savers and borrowers as per their preferences.
- Banks monitor their borrowers continuously to ensure prudent use of loans for the stated purpose.
- **Prudential use**- This reduces the moral hazard problem, the risk of default, saves time and effort from duplication of monitoring by numerous bank depositors.
- **Diversification of portfolio**- Banks, with their access to large pool of deposits, lend to a variety of economic activities and borrowers, thus reducing the overall risk.
- Thus, despite loan default by few individual borrowers, bank deposits remain safe.

Supporting evidences

- In India, after bank nationalisation in 1969, there was a substantial rise in the saving rate from 10-12% in 1960s to nearly 18-20% during late 1970s and 1980s.
- With comprehensive banking reforms, the saving rate increased to 36-38% by late 2010s.

References

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Quick facts

Sveriges Riksbank Prize in Economic Sciences

- The economics prize is not one of the original five awards created in the 1895 will of industrialist and dynamite inventor Alfred Nobel.
- It was established by Sweden's central bank in 1968, as the **Sveriges Riksbank Prize in Economic Sciences** in memory of Alfred Nobel.
- It is also known as the Nobel Prize in Economics.
- The Prize in Economic Sciences is awarded by the **Royal Swedish Academy of Sciences**, Stockholm, Sweden, according to the same principles as for the Nobel Prizes that have been awarded since 1901.
- The first Prize in Economic Sciences was awarded to Ragnar Frisch and Jan Tinbergen in 1969.

Keynesian economics

- Keynesian economics is considered a **demand-side theory** that focuses on changes in the economy over the short run.
- Its central belief is that **government intervention** can stabilize the economy.
- Keynes developed his theories in response to the Great Depression.
- Activist fiscal and monetary policy are the primary tools recommended by Keynesian economists to manage the economy and fight unemployment.

Central bank discount window

- The discount window is a central bank lending facility meant to help commercial banks manage short-term liquidity needs.
- Banks that are unable to borrow from other banks may borrow **directly** from the central bank's discount window.

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