Economics Nobel Has Lessons for India's Macro-Economic Policy Thought

thewire.in/economy/economics-nobel-lessons-india-macro-economic-policy-thought

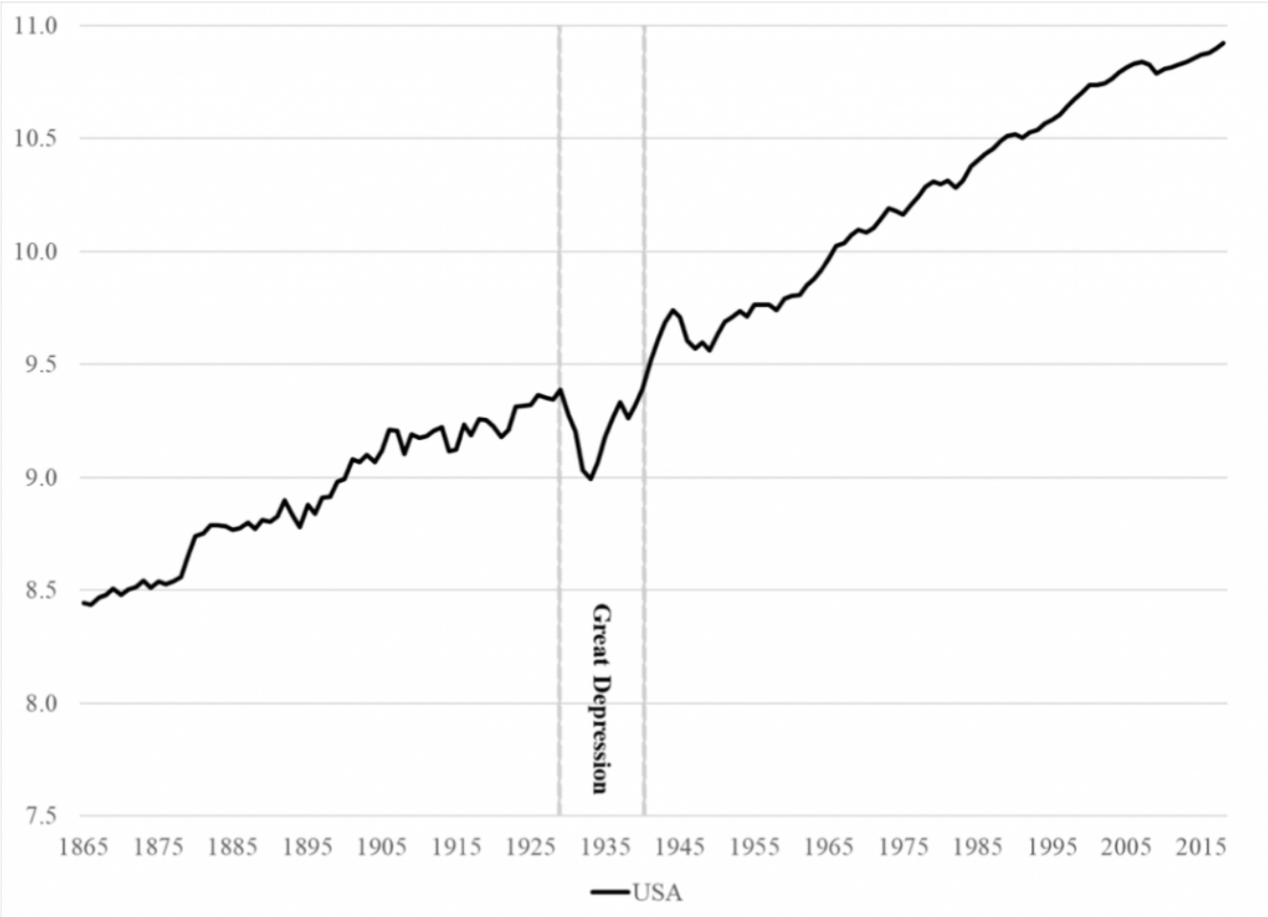
This is a longer version of a piece that was first published on The India Cable – a premium newsletter from The Wire & Galileo Ideas – and has been republished here. To subscribe to The India Cable, click here.

Seminal contributions by Ben Bernanke, Douglas W. Diamond, and Philip H. Dybvig made in the foundational research on the role of banks in the economy during financial crises was rewarded with the 2022 Sveriges Riksbank Prize in Economic Sciences, in honour of Alfred Nobel.

Two parallel research projects that originated in the early 1980s, according to the Prize, both, motivated by the experiences of the banking sector during the Great Depression, significantly advanced one's understanding of the role banks play in the economy.

Douglas Diamond and Philip Dybvig developed theoretical models to explore the banks' role and why they are/were vulnerable to crises.

Ben Bernanke, who was also the chairman of the Federal Reserve from 2006 to -2014, after Alan Greenspan, for a period of severe crisis seen in the US economy worst since the Great Depression, also conducted empirical research (in his academic work) addressing the same questions (like Diamond and Dybvig).

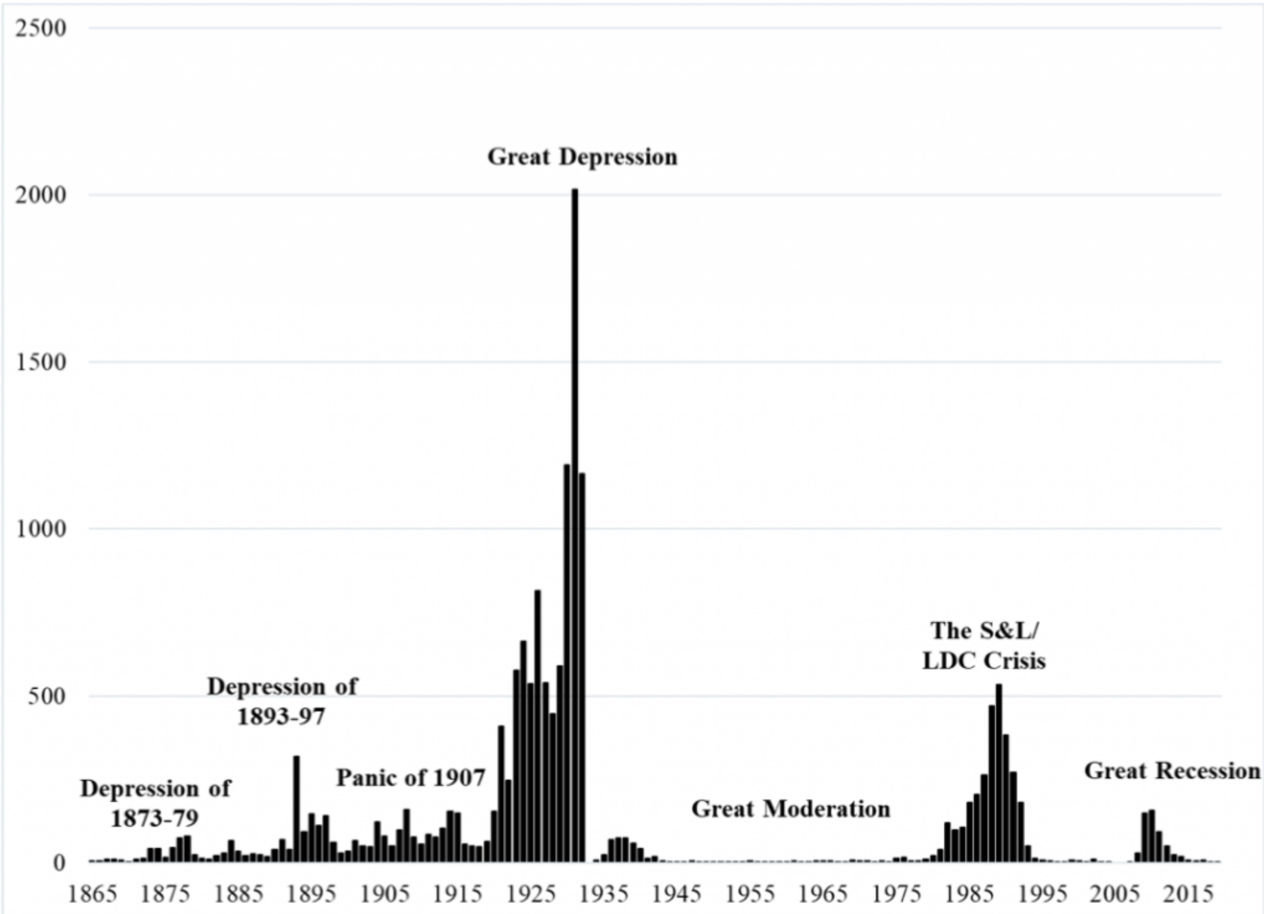


Source: Nobel Prize in Economic Sciences (2022) Scientific Paper.

Bernanke studied The Great Depression: the deepest and longest economic downturn in recorded history. This was an event, or a crisis shock, that initiated in the US but soon became a global crisis shock. He provided historical documentary evidence and empirical data to uncover the importance of the credit channel for the "propagation of the depression".

Also read: Nobel Prize for Economics Goes to Bernanke, Diamond, Dybvig for Research on Financial Crises

Bernanke's academic work explained why and how the depression became so deep, given how the bank failures at the time destroyed valuable banking relationships, and the resulting credit supply contraction left significant scars on the economy.



Source: Nobel Prize in Economic Sciences (2022) Scientific Paper.

These were new insights given most economic historians writing on the depression, including Keynes, Milton Friedman, and Anna Schwartz (who) had viewed/interpreted bank failures because of the downturn, or merely responsible for contracting the overall money supply, rather than directly damaging macro-investments through severed credit arrangements.

The Prize in context to India's economic landscape

I see this year's Nobel Prize is also critical in context to the current economic landscape in India and the world.

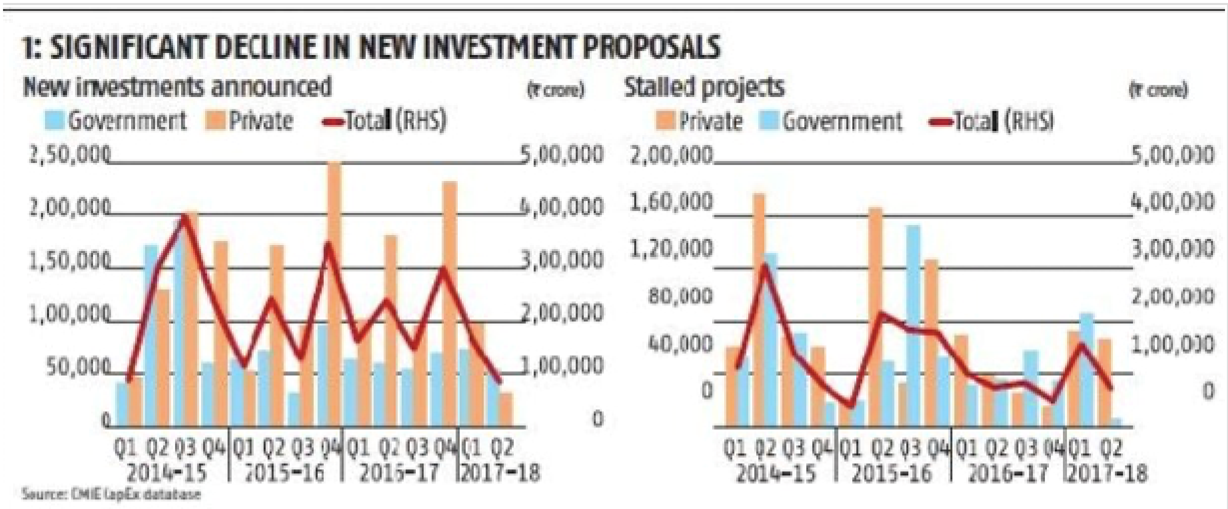
Most nations are still struggling from a covid-wrung economy (demand side and supply-chain issues), suffering from high inflation, a high fiscal deficit due to excessive spending undertaken during the shutdowns, with other macroeconomic imbalances resulting from a deeply polarised political landscape, and a war.

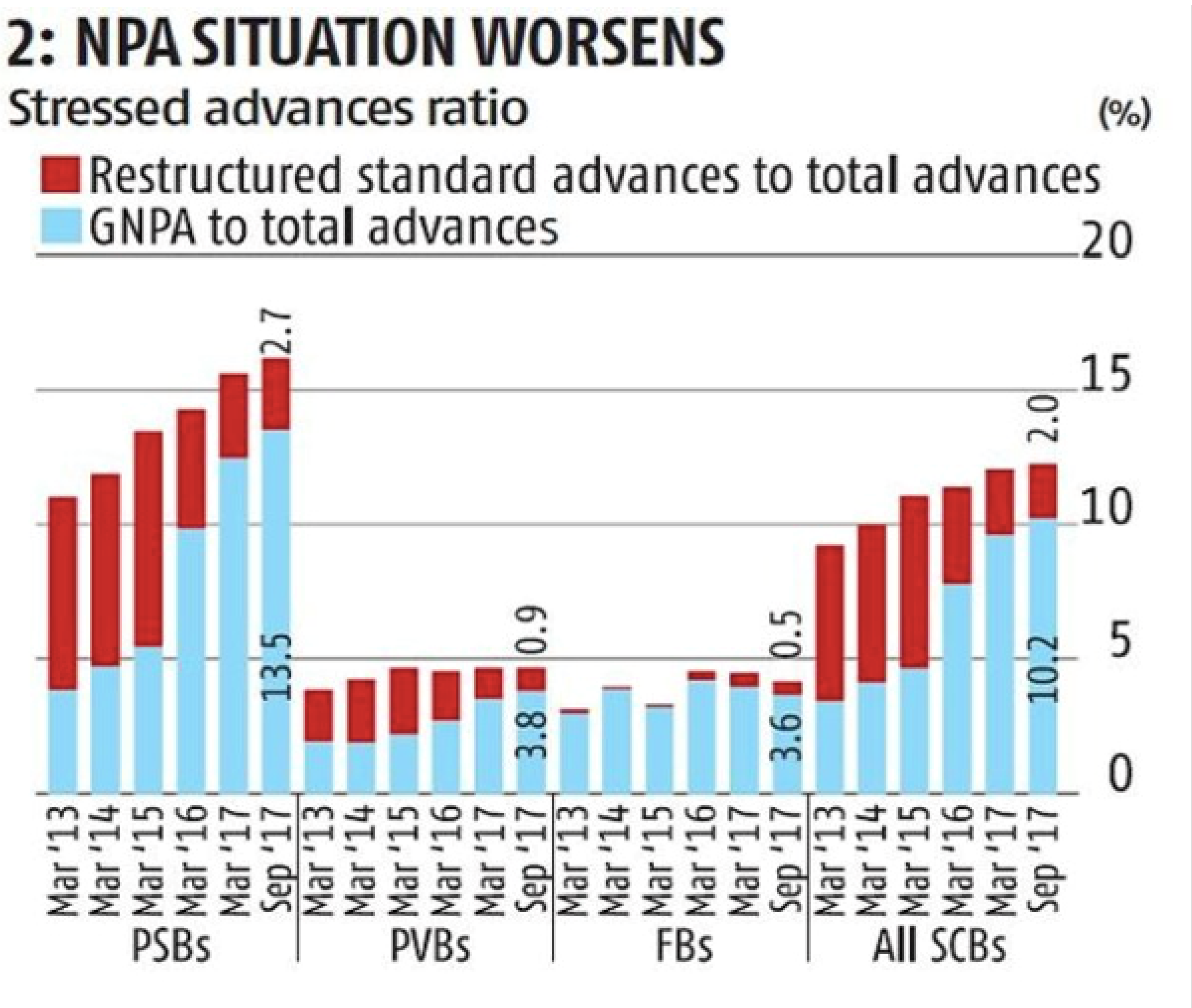
Prophetic alarm bells are predicting a deeper recession on the horizon in many parts of the industrialised West with significant spillover effects on emerging market economies (like India), slowing down trade expansion possibilities and private investment. Growth's already low, unemployment higher, labour markets broken, protectionism on the rise, and debt-deficits are soaring.

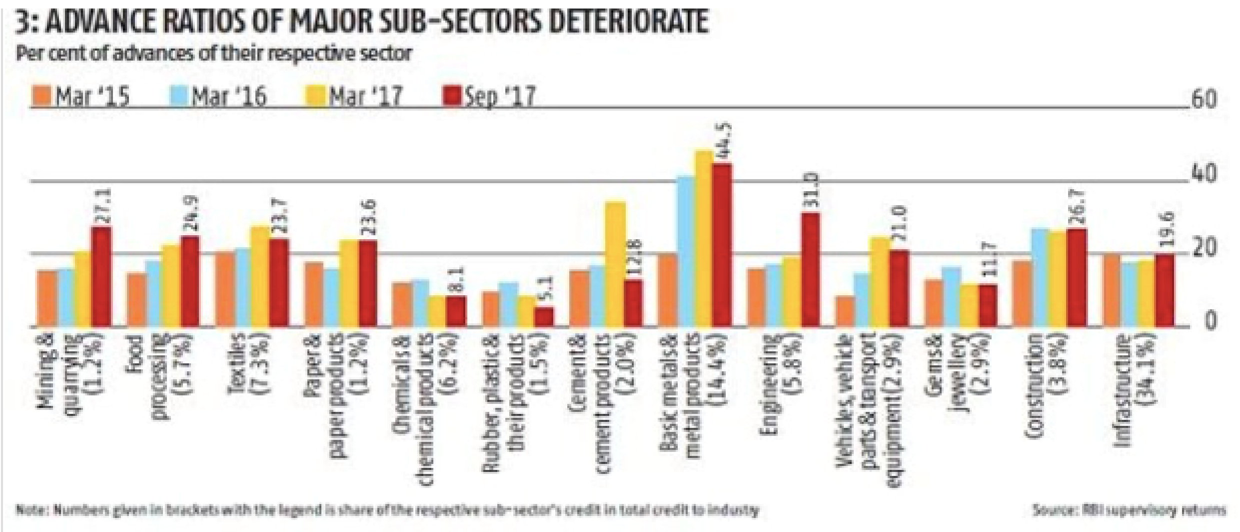
Amidst a strong dollar surge, causing exchange rates to unfavourably affect weaker currencies, the Indian Rupee too may continue to remain in the shadows of an uncertain, volatile global economic landscape.

But, the situation, as some of us have argued previously, was bad from a time much before covid struck. The pandemic may have only helped the government in changing the crisis narrative to attribute most of the current state of the economy's blame to "pandemic-induced distortions/disruptions".

Look at two key markers here: 1) evidence from a twin balance sheet problem affecting public sector lending in/across India (a high number of stressed investment projects, NPAs), and 2) aggregate slowdown in overall private investment (due to rising stalled investment projects).

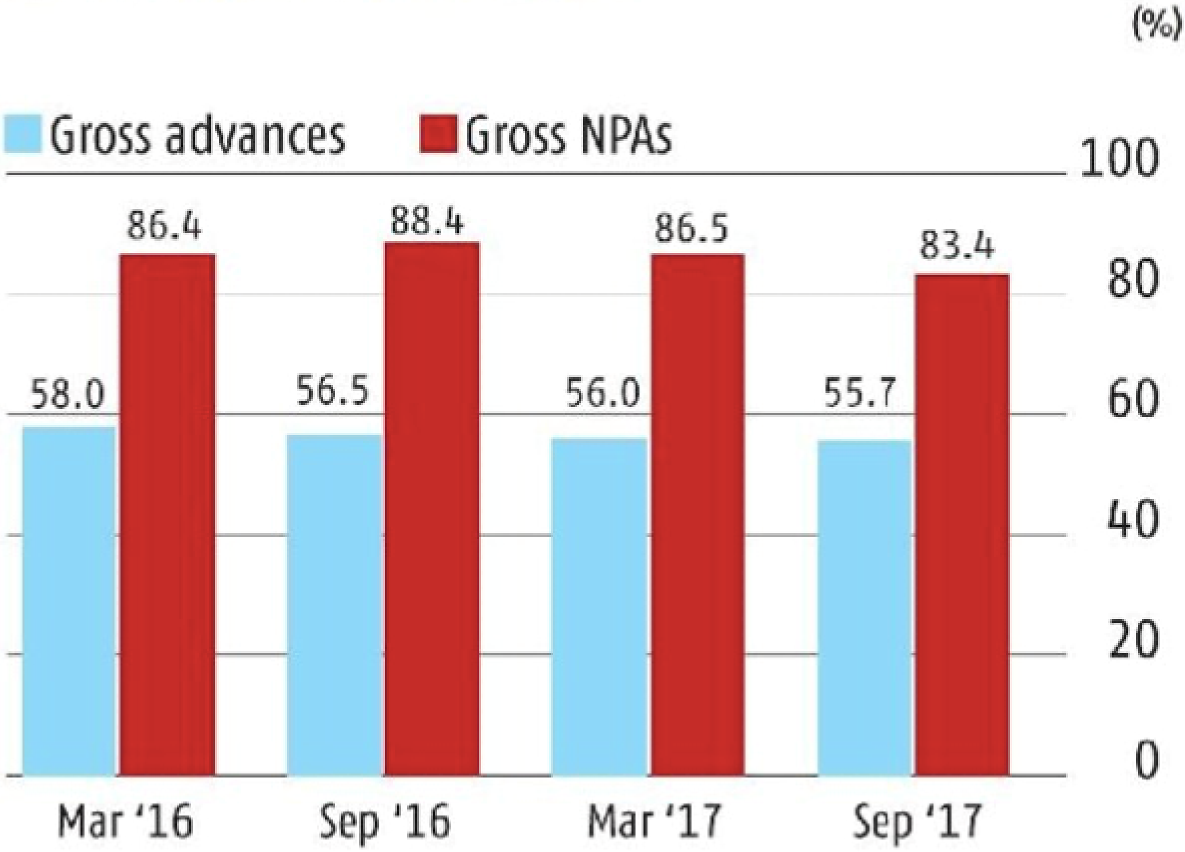




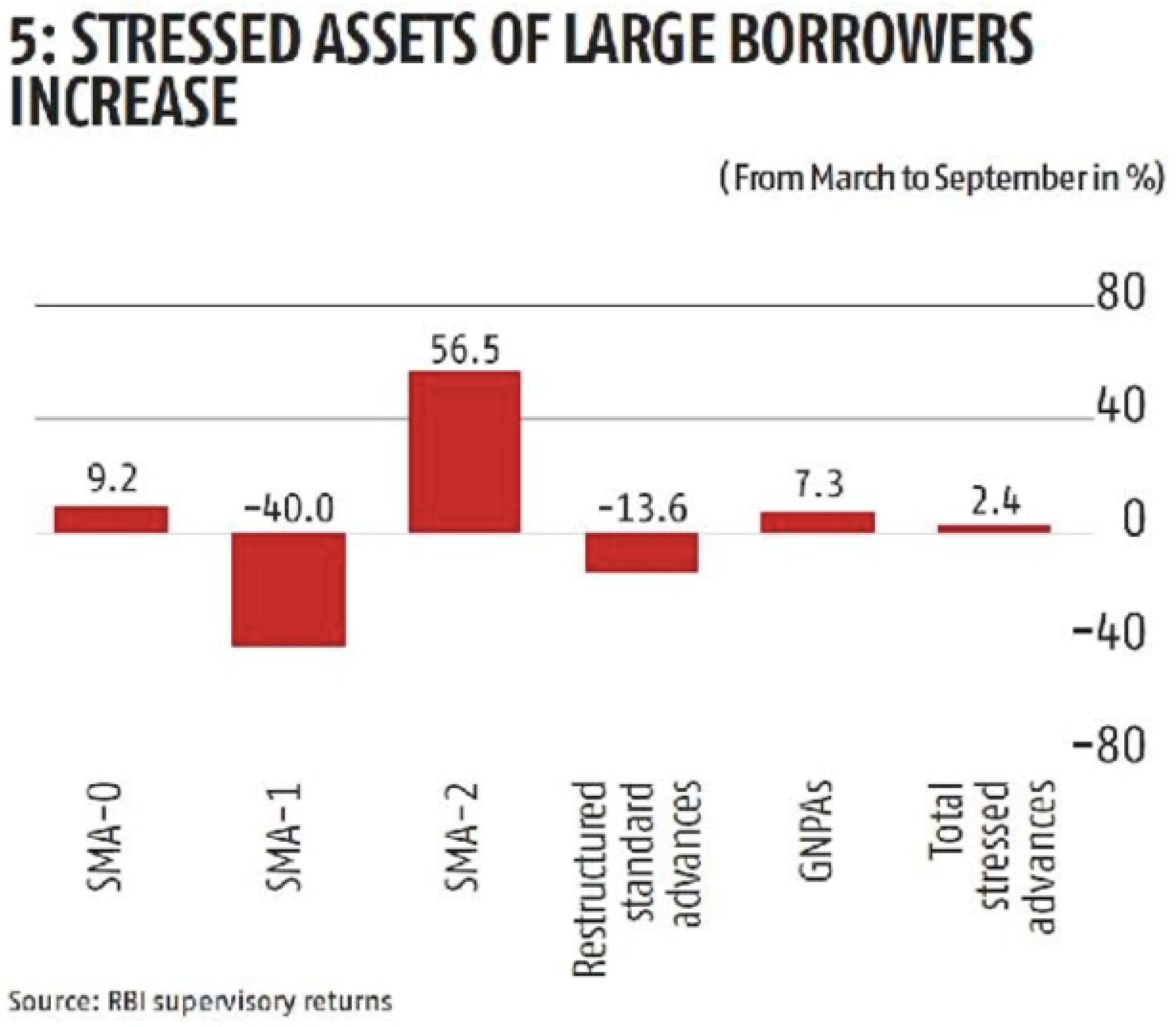


The above and below charts from *Business Standard* (originally sourced from RBI, CMIE data) provide a comprehensive scenario explaining the pre-covid stressed banking space, clogged with high NPAs, poor loan recovery and a perspective on sectors that have the maximum vulnerability to bad loans/debt. The share of large borrowers in the scheduled commercial bank loan portfolio was unusually high at 83.4% pre-covid in 2017.

4: SHARE OF LARGE BORROWERS IN SCBs' LOAN PORTFOLIO REDUCES



Source: RBI supervisory returns



The other key issue is the slowing down of private investment in/across India. A stressed banking sector has accentuated this, but there are political economy reasons as well (see Pranjul Bhandari's research extrapolations in a few charts below):

Visible economic fault lines in India's banking-finance and investment landscape must make policymakers and those in charge of decision-making of central monetary and financial institutions to go back in the past for guidance on policy-intervention options and key markers to watch out for.

Also read: What Should the Future of Indian Banking Look Like?

It is here where the work of Bernanke, Diamond, Dybvig et al. becomes crucial. The laureates' research generated three complementary insights, each with a lasting impact both on research and policy (quoting below):

1. Valuable maturity transformation is inherently vulnerable (Diamond and Dybvig, 1983).

Bank lending is short-term because a regular household typically wants its savings to be available "on demand," while investors typically need to borrow money over long horizons. By pooling funds from many savers, who may each demand liquidity but who are unlikely to all do so at the same time, the intermediary can fund long-term projects that offer higher returns.

The bank deposit contract enables savers to share the risk they face because the timing of their consumption needs is uncertain, and it makes all savers better off than they would be without the bank. Effectively, the bank transforms long-term borrowing into short-term lending: they create liquidity. However, the very nature of maturity transformation makes banks vulnerable to self-fulfilling runs; concerns that other people will demand their deposits back, leading the bank to have insufficient funds, may lead all savers to run to the bank to withdraw their money.

Even fundamentally healthy banks may get into trouble if such bank runs become widespread. Government policies, such as insuring deposits or a central bank acting as a lender of last resort, can help prevent bank runs.

2. Delegated monitoring allows savers to get access to safe, high returns (Diamond, 1984).

By using their expertise in evaluating and monitoring borrowers, and by pooling funds from many savers and diversifying across borrowers, banks reduce the aggregate monitoring costs that would otherwise have been borne by borrowers. This enables households' savings to be channelled to productive investments at a lower cost.

Jointly, these two theoretical contributions explain how financial intermediaries create liquidity in the economy. On the liability side, banks pool many savers together, which enables savers who end up needing liquidity to have their demand met by long-term savers who do not need liquidity at the same moment in time. On the asset side, banks pool many loans together and monitor them on behalf of

3. Financial intermediation is key for real activity (Bernanke, 1983)

Historical documentary evidence and empirical data from the Great Depression show that bank runs had major real and long-run economic consequences. Banks provide important screening and credit-monitoring services, and they develop crucial long-term relationships with borrowers."

When banks failed in large numbers in the past, existing banking relationships were destroyed, and it took time to build new relationships. The result was a severe credit crunch affecting primarily households, farms, and small businesses, and this deepened and prolonged the Great Depression. In other words, the effects of the recession were exacerbated through the credit channel (much like of what we might see in India if the twin balance sheet problem isn't reversed).

Indian policymakers, in understanding the reasons for a twin-balance sheet problem, may also want to closely rely on sound macro-economic history evidence to see how a sustained correction in NPAs remains possible, which is vital to driving credit growth for increased private investment, which subsequently shall help with a higher production-and GDP growth performance.

Yes, it is true that there is less chance now (more than ever before) of the next major global economic crisis surfacing from the banking sector alone (as seen during the Depression of the late 1920s and the Great Recession of 2007), thanks to the work contributed by scholars like Diamond et al. making cross-border bank regulation possible. In India, that may not be the case.

The real concern, for now, lies with the stressed nature of India's banking and finance landscape, accompanied by an excessive (public-private) debt accumulation happening in India-and across the globe with a rise of overleveraged economies, slowing down growth and production capacity. These may become a critical catalysing factor to trigger the next Indian economic crisis if immediate corrective measures through policy and reform aren't considered.

Deepanshu Mohan is associate professor of Economics and director, Centre for New Economics Studies (CNES), Jindal School of Liberal Arts and Humanities, O.P. Jindal Global University.