This year’s Economics Nobel prize for research about the 1930s holds key lessons for current crisis

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Representative image. | Reuters

The research projects for which Ben Bernanke and the team of Douglas Diamond and Philip Dybvig were awarded this year’s Nobel Prize in economics originated in the early 1980s. They were motivated by the experiences of the banking sector during the Great Depression that started in 1929.

The insights offered by these economists played a significant role in helping develop an understanding of the role banks play in the economy, which are critical in the context of today’s global economic landscape.

Diamond and Dybvig developed theoretical models to explore the role of banks and why they are vulnerable to crises. Bernanke addressed the same questions. He would go on to become chairman of the US Federal Reserve from 2006-2014, when the US experienced a period of severe crisis – its worst since the Great Depression.

Today, most nations are still struggling with Covid-wrung economies that caused supply-chain disruptions. They are suffering from high inflation, a high fiscal deficit due to excessive spending during the shutdowns to prevent the spread of the coronovirus, macroeconomic imbalances resulting from a deeply polarised political landscape, and a war.

Recession warnings

Prophetic alarms are being rung about the potential for a deeper recession in many parts of the industrialised West, slowing down trade and investment with significant spillover effects on emerging market economies. Growth in most parts of the world is already low, unemployment higher, labour markets are broken and budget deficits are soaring.

This is contributing to an environment of grave uncertainty and drawing out both private foreign and domestic capital from emerging market economies (including India). Amidst a strong dollar surge, further causing exchange rates to further hurt weaker currencies, many emerging market economies may remain in the shadows of an uncertain, volatile economic landscape.

These economic fault lines have prompted policymakers and those in charge of decision-making at central monetary and financial institutions to go back in the past for guidance on policy-intervention options and key markers to watch out for. It is here where the work of Bernanke, Diamond, Dybvig is crucial.

> BREAKING NEWS:
> The Royal Swedish Academy of Sciences has decided to award the 2022 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel to Ben S. Bernanke, Douglas W. Diamond and Philip H. Dybvig "for research on banks and financial crises."#NobelPrize pic.twitter.com/cW0sLFh2sj
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> — The Nobel Prize (@NobelPrize) October 10, 2022

Diamond and Dybvig showed that an institution using demand deposits to finance long-term lending is perfectly suited to satisfy the conflicting needs of both savers and borrowers. Savers need liquifiable assets to satisfy sudden spending needs. Borrowers need long-term commitments to be able to finance investments that cannot be prematurely liquidated without large costs.

Banks tend to do this by turning illiquid assets into liquid assets (A liquid asset is one that can be quickly sold without a significant loss in value; an illiquid asset is one that can't be quickly resold without a significant loss in value. For example, holdings in a bank account are liquid assets).

According to the prize research paper statement, "Diamond (1984) showed that the way banks are constructed is key for their ability to act as delegated monitors."

In practice, small lenders cannot themselves undertake the monitoring of all final users of their savings – the task needs to be delegated. On who should monitor the bank, Diamond's work showed that "a debt contract between lenders and the bank, along with diversification, provides the bank with the right incentive to monitor".

In simple terms, the "monitoring task" described by Diamond requires knowledge about the borrower, which takes time to build, and it is difficult to transfer this information to other banks. Bernanke has used this finding to explain how and why bank failures triggered financial crises like the Great Depression were so protracted in nature.

Importance of credit channels

Bernanke provided historical documentary evidence and empirical data to uncover the importance of credit channels for the "propagation of the depression". He explained how and why the depression became so deep: bank failures at the time destroyed valuable banking relationships, and the resulting credit supply contraction left significant scars in the economy.

All these were new insights. Until then, most economic historians writing on the depression – including John Maynard Keynes, Milton Friedman and Anna Schwartz – had viewed bank failures to be the result of the economic downturn, or merely responsible for contracting the overall money supply, rather than directly damaging macro-investments through severed credit arrangements.

This has ensure greater (and more robust) banking regulations in the world we live in.

Thanks to the work of these scholars making cross-border bank regulation possible, there is a less chance now of the next major economic crisis surfacing from the banking sector alone (as it did during the Depression of late 1920s and Great Recession of 2007),

However, the real concern may lie with the excessive public-private debt accumulation the globe with the rise of overleveraged economies seeing a slowdown in growth and production capacity. This may become a critical catalyding factor to trigger the next global economic crisis to watch out for.

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