Why are banks necessary for us?

Mohammad Riyas

The Nobel Memorial Prize in Economic Sciences has been awarded to three economists of the U.S - Ben S. Bernanke, Douglas W. Diamond and Philip H. Dybvig. The theories they have been honoured for delve deep into how banks play a major role in the economic operations and what will happen in the economy when banks go bust.

This article explains how far these theories are so important that the three economists have been honoured with the award.

In the 1920s when the World War-I had ended, the United States of America was at the peak of economic prosperity. The people had an easy money flow. Everywhere it was fun and frolic for the people.

The war-ravaged European countries began reconstructing themselves and so made heavy imports from the U.S. Hence, the U.S. companies were enjoying their heyday.

During this period, the stock markets in the U.S. were developing by leaps and bounds with the people, affluent and middle-class, buying shares as if they were purchasing commodities across the counter in provision stores. As a corollary, the companies manufactured goods bountifully. So, the supply exceeded demand.

But the situation started changing very soon. Production in the European countries picked up steam after they broke free from the inimical impact of the World War-I. So, they naturally stopped making heavy imports from the U.S. In a cascade effect, the U.S. companies, which had manufactured goods over and above demand, lost market and started floundering. The losses they incurred reflected badly on the value of their stock on the bourses too. Even as share prices crashed like nine pins, the stock market went into a tailspin, setting off panic and fear among the U.S. investors most of whom were middle-class people. The government, in a damage control exercise, imposed heavy taxes on imports.

October in 1929

In October, 1929 in the U.S. economy, the Great Depression set in. The avalanche of stock market crash pushed the banks down into a heart-wrenching crisis because the companies to which the banks had lent indiscriminately turned defaulters. The bad loans led the banks to go bankrupt and the investors kept flocking to them to retrieve their savings and investments.

The U.S., which was a country of economic prosperity and entertainments in the early 1920s, was turned upside down after 1929.

The impact of natural disasters such as earthquake, storm, deluge and so on can be seen in concrete terms; buildings would lie in a shambles; roads and bridge would be reduced to rubbles and electric poles overturned.
But the impact of economic disaster could be a tough nut to crack and could not be as easily understood as natural disasters are.

During the Great Depression that sent the U.S. reeling in 1929-1939, all sectors nosedived. Several companies left in the red were closed for want of investment and capital. Most of the people faced unemployment. Over the time banks went bust and downed shutters.

Most of the later-day research findings on the massive economic crisis in the U.S. during this period said that had the U.S. government printed currency notes abundantly, the crisis that sent the banks crashing could have been avoided.
This had been a general perception till 1983 when Bernanke published his research that delved deep into the banks' role in economic operations.

Bernanke's contribution

Bernanke in his research on the Great Depression proved that it was not because of the economic crisis that banks crashed in the U.S. Rather it was because banks turned bankrupt that the economic crisis arose. His finding made a paradigm shift in the general perception about the banks.

The essence of his research is that if only the U.S. government had taken measures on a war-footing to retrieve and redeem the banks swarmed by investors gripped with fears of bankruptcy, the intensity of the economic crisis could have been eased. So long as the banks are in a seamless operation, a country's economy will continue to be active; that is to say, the companies will give priority to investing in industrial ventures. When an economic operation is kept robust, it can prevent crises. When we allow the banks to crash, the failure will lead to paralysis of the whole economic operation.

Of course, economic crisis is inevitable. But its intensity can be lessened. For that, the banks are important. This is what Bernanke has proved through his research. He also got an opportunity to prove the veracity and validity of his theory. Bernanke was the chairman of the Federal Reserve in the U.S. during 2006-14. In 2008-09, the world was faced with a great economic crisis akin to one in 1929. But unlike in 1929, the millennial crisis that witnessed the stock markets crashing reflected on the world countries immediately.

The 2008 stock market crash led several people in the U.S. to commit suicide. There were umpteen instances of people floundering in the neck-deep debts. But unlike in 1929, the 2008-09 crisis did not last long, reportedly thanks to the measures taken by Bernanke, who was the chairman of the Federal Reserve then. In his first-phase measure, he stopped banks from going bust by providing them the necessary funds. As a result, the crisis was resolved within two years, it is said.

Similarly, the resolution of the crisis triggered by the Corona pandemic was attributed to the implementation of his theories. It is for this contribution on his part that he has been honoured with the Nobel Prize.

Contributions of Douglas Diamond and Philip Dybvig

Why are there banks in the human society? What if there are no banks at all?

Imagine there are two groups of people, one group willing to save up their own money and another in need of loans for their business.

Is it possible for the first group to identify the companies to which they can lend money? And is it possible either for the companies in need of capital to go after the people flush with funds? Even if the companies identify the prospective lenders, how much can they borrow?

This is where the banks step in, assuming importance and serving as bridges between the investors and the borrowers.
Banks get money from the people who want savings and lend it to the needy. It is just because banks exist that the people who save up their money can draw funds whenever they need them. The people who want funds for their business take bank loans on the long-term basis.

Thus, the banks convert the people's savings into energy for the economic operations. Without the banking mechanism, this kind of conversion is not possible. That is the essence of the theory jointly invented by Douglas Diamond and Philip Dybvig in 1983.

It is only through banks that various sectors get loans for their development. When one of the sectors finds itself in a crisis, the banks can sustain themselves with the help of the funds repaid by the other sectors.

Moreover, the banks can monitor if the loans obtained by the companies are used for the purpose they are originally meant for, said Douglas Diamond in his separate research in 1984.

While Bernanke proved through his research in 1983 why banks are necessary for the economic operation, Douglas Diamond and Philip Dybvig demonstrated how economy operates through the banks and put forward suggestions on how to stop banks from going bankrupt.

If rumours of a bank going bust spread like wildlife among the investors, what will happen? The people who have accounts with the bank will flock to the bank to retrieve their money. But the bank may not be in a position to honour its commitment towards the account-holders en masse because it may have only a portion of the investors' money, having lent major chunks of the funds to various persons or companies. As a result, the bank may go bankrupt. This was what exactly happened way back in 1929.

In this kind of situation, the government must get the investors' money insured, said these economic experts in their researches.

Their theories may at present strike one as quite simple. But till these theories were invented, there had been no proper understanding of the banking concept's indispensable role in the economic development of a country.

It is these three economic experts, who had systemized theories about the link between the banks and the economic operations. It is their theories which have helped several world countries formulate their own banking policies and tackle successfully the economic crises, said the Nobel Prize selection committee.

At present, Bernanke is a distinguished senior fellow with the Economic Studies program at the Brookings Institution in Washington. Douglas Diamond is working in Chicago University and Philip Dybvig in the Washington University.
Hats off to them!

- Mohammad Riyaz, for contact - riyas.ma@hindutamil.co.in

Translated by V.Mariappan.