Prize in Economic Sciences 2022

Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel

"The role of banks in financial crises"

The work of this year's laureates has improved our understanding of banks, bank regulations and how financial crises should be managed.

Brief History

Alfred Nobel did not choose Economic Sciences as one of his prize categories. Instead Sveriges Riksbank, at its 300th anniversary in 1968, established an Economic Sciences prize in memory of Nobel. It was awarded for the first time in 1969 and is called the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel.

The prize is presented at the same ceremony as the Nobel Prize, on **10 December** each year. The prize is awarded to a person or persons who have produced works of outstanding importance in the field of economic sciences. The laureates have analysed various economic problems and found ways to solve or understand them.

The 2022 Prize Winners:

Ben S. Bernanke is a fellow at the Brookings Institution and was previously the head of the Federal Reserve, which is the central bank of the United States.

Douglas W. Diamond is a professor at the University of Chicago, but he has taught at a number of different universities in both Europe and Asia.

Philip H. Dybvig is a professor at Washington University in St. Louis. He spends summers leading a research programme in Sichuan, China.

The Banking System

Most people have some sort of contact with a bank several times a week. Maybe they pay for things with a credit card or a mobile payment app, or they have money saved in an account at the bank. The same is true for businesses.

In times of economic crisis, there is a risk that this system breaks down and banks collapse. When that happens, it causes problems for the entire economic system. In addition to people losing the money they had saved in the bank, it also becomes harder to buy things and to borrow money. And if several banks collapse at the same time, it becomes difficult for companies to borrow, to invest and to get paid by their customers.

The work of this year's laureates has improved our understanding of banks, bank regulations and how financial crises should be managed. That has made it possible to manage recent financial crises better and to avoid the kind of deep and longlasting depression we experienced in the 1930s.

Bank crisis led to a depression

In 1983, **Ben Bernanke** wrote an article in which he analysed the Great Depression of the 1930s which paralysed the world's economies for many years and had enormous consequences for society. It wasn't until the middle of that decade that the world's economies slowly began to recover.

Until Bernanke wrote his article, most experts believed that the depression could have been prevented if only central banks had printed more money. Bernanke did concede that it would have helped if more money had been printed, but he concluded that this wasn't what made the crisis so severe.

Instead, Bernanke showed that the reason the crisis became so deep and protracted was that many people withdrew their savings from their bank in fear of losing all of it in a bank collapse. It turned into what's known as a "**run on the banks**" or a "**bank run**".

If enough people withdraw their savings at the same time, the bank will not have enough reserves to give everyone their money back, and they will be forced to sell off their assets in a panic at great loss. In extreme cases, the bank can be forced into bankruptcy.

In the 1930s, this led to a rather normal recession spiralling into a bank crisis. The banks that survived it became more cautious about lending money to private people and businesses, making it harder for them to finance the investments they needed to make. The result was the greatest economic depression in modern history.

Why do we need banks?

This year's other two laureates, **Douglas Diamond** and **Philip Dybvig**, developed theoretical models, also published in the 1980s, that explain why we have banks. That knowledge is important in explaining how a bank crisis can have such devastating consequences for the national economy.

A bank has two main functions: they take in deposits from people with money to save and lend it out to those who need money to spend. The savers want to be able to withdraw their money quickly in case the need should arise. At the same time, those who borrow need to be sure that the bank is not going to suddenly demand its money back.

Banks resolve these needs both for savers and for borrowers. Without banks making it possible to save, borrow and make payments, our society would not work.

Banks are vulnerable to rumours

What banks do is important to the functioning of our society. At the same time, the banking system is vulnerable. A rumour that the bank is short of money can make savers worried there won't be enough when they go to withdraw their savings. Even if the rumour is false, this can lead to many people rushing to withdraw their money before it runs out. This results in a bank run.

This vulnerability is described by Douglas Diamond and Philip Dybvig in their research. They also presented a solution to the problem in the form of a government deposit insurance programme. When depositors know that the government guarantees they'll get their money out, they don't need to rush off to the bank at the first rumour of a bank run.
The insurance stops bank runs before they even get started.

Banks monitor their borrowers, but who's monitoring the banks?

In a 1984 article, **Douglas Diamond** described another of a bank's most important jobs, which is to monitor their borrowers and the investments they make with the bank's money.

The bank monitors borrowers to ensure they're doing a good job of managing their investments. They first assess a borrower's credit, or ability to pay back, and then follow up to see how the investment they make with money is going. This reduces societal costs by cutting down on the number of bankruptcies.

But if banks monitor their borrowers, who's monitoring the banks? According to Diamond, banks could eventually lose a lot of money if they lend to people who can't pay them back. It is therefore in the bank's interest to monitor the borrowers they invest in in order to minimise their losses.

Because banks have this incentive to monitor their investments, Diamond asserts, they do not need to be monitored by depositors.

The foundation for modern bank regulations

Douglas Diamond and Philip Dybvig's work on the importance of banks and their vulnerability has laid the foundation for how governments can best regulate banks and create stable economic systems.

Ben Bernanke's analyses of the crisis of the 1930s have made it possible for us to avoid making serious mistakes when economic crises come.

The laureates' work laid the foundation for how many countries responded to the crisis that threatened at the start of the **Coronavirus pandemic in 2020**.

Thanks to their research, society today is better equipped to manage economic crises and avoid long-term economic depression.

Comments following the Announcement

In a telephone interview given in conjunction with the announcement of the Prize in Economic Sciences 2022, Douglas Diamond describes the joy of being awarded the prize along with Philip Dybvig and Ben Bernanke. Diamond says of the 2007 financial crisis that the world was incredibly lucky that Ben Bernanke happened to be the head of the central bank of the United States at the time.