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Nationalizing Banks to Jumpstart the Banking System

CEPS Commentary/10 October 2008

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The essence of what banks do in normal times is to borrow short and to lend long. In doing so, they transform short-term assets into long ones, thereby creating credit and liquidity. Put differently, by borrowing short and lending long, banks become less liquid, thereby making it possible for the non-banking sector to become more liquid; that is, have assets that are shorter than their liabilities. This is essential for the non-bank sector to run smoothly.

This credit transformation model performed by banks only works if there is confidence in the banks and, more importantly, if banks trust each other. This confidence has now evaporated and, as a result, the model fails. The generalised distrust within the banking system has led to a situation where banks do not want to lend any more. That means that they continue to borrow short but lend equally short; that is, acquire the most liquid assets. The result is a massive destruction of credit and liquidity in the economy. The non-banking sector cannot borrow long so as to acquire liquid assets that they need to run their business, because banks do not lend long anymore. This risks bringing the economy to a standstill. A depression is looming.

It is important to realise that this liquidity crisis is the result of a co-ordination failure: bank A does not want to lend to bank B, not necessarily because it fears insolvency of bank B but because it fears other banks will not lend to bank B, thereby creating insolvency of bank B out of the blue. Thus bank lending comes to a standstill because banks expect bank lending to come to a standstill.

How to get out of this bad equilibrium? There is only one way. The governments of the major countries (US, UK, the eurozone, possibly Japan) must take over their banking systems (or at least the significant banks). Governments are the only institutions that can solve the co-ordination failure at the heart of the liquidity crisis. They can do this because once the banks are in the hands of the state, they can be ordered to trust each other and to lend to each other. The faster governments take these steps the better.

Government interventions have consisted of recapitalising banks. These have not worked. The main reason is that they have been triggered by bank failures as they pop up and, as a result, have only dealt with the symptoms. The liquidity crisis is pulling down asset prices in an indiscriminate way, thereby transforming the liquidity crisis into solvency problems of individual banks. The governments then are forced to step in and to recapitalise the bank only to find out later that when the liquidity crisis strikes again,

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the capital has evaporated. The governments throw fresh capital into a black hole, where it disappears quickly.

Central bank liquidity provision, although necessary, has also failed to address the co-ordination failure and has only made it easier for banks to dispose of long assets to acquire short ones (cash). Thus central banks' liquidity provisions do not stop the massive destruction of credit and liquidity that is going on in the economy.

The recent decision of the US Federal Reserve to bypass the banking system and to lend directly to the non-banking sector by buying commercial paper is a step in the right direction. It allows companies to obtain cash by borrowing long; a service banks do not want to provide anymore. The step taken by the Fed is insufficient, however. The Fed cannot take over all bank lending operations. Only the government can do this by temporarily transforming private banks into public ones. It can then order the management of these state banks to lend to each other.

Such a transformation (call it a temporary nationalisation) will make it possible to jump start the interbank market and allow the normal flow of credit to be activated. Nationalising the banking system is not the only intervention necessary. There is today a general distrust of private debt. This will force the government to substitute private debt for public debt. The Paulson plan does just that. More Paulson plans will be necessary to put a floor on the price of private debt and to prevent a meltdown.

The temporary nationalisation of the banking system and the substitution of private debt by public debt will allow us to reach a new equilibrium. When this happens, a fundamental reform of the banking system will be necessary in order to remain in this benign equilibrium. When this is achieved the governments will be able to privatise the banking system again.