It is an honor to be here today in Paris, at Banque de France, to receive the inaugural Banque de France and Toulouse School of Economics Junior Prize in Monetary Economics and Finance. My heartiest congratulations to Klaus Adam, the other recipient of the Junior Prize, and Bengt Holmstrom, the recipient of the Senior Prize. I consider myself fortunate to be in their elite company today. It is certainly a relief to be reminded that I am still under 40. It is an even bigger relief that the Jury for the Prize, through its generous decision, has helped me convince my family that I am doing something useful with my life. But most satisfying is the fact that research in the area of financial intermediation and its regulation is finally finding traction more broadly. For a long time, this work has been somewhat sidelined in the academic profession except by a small set of prescient researchers, many of whom are in the room today.

Rather than summarizing several years of my research in this area, undertaken at NYU Stern and London Business School, I have chosen to read a slightly edited version of Introduction from my recent essay, titled “Governments
as Shadow Banks: The Looming Threat to Financial Stability”. This summarizes best where my research is headed at the current point of time.

Most discussion of macro-prudential regulation of the financial sector focuses on banks and intermediaries in the private sector. However, governments are themselves heavily involved in intermediation, either explicitly in the form of government-sponsored enterprises (GSEs), or implicitly in the form of government guarantees to the private sector intermediaries. The government involvement also extends to determining the nature of regulation in the financial sector, in the form of policies governing competition among financial firms, rules for prudential risk controls, and setting of leverage limits or equivalently capital requirements. Through the design of these policies, governments exercise a significant control over the extent and quality of intermediation activity and the attendant risks. This is true not just for the so-called emerging market economies where there is a high level of explicit state-ownership of banks, but also in the developed Western economies where there are some – often large government-sponsored enterprises, notably in housing finance – and where the implicit guarantee of the financial sector has been substantial. At any rate, if the law-making process for financial sector reform of the past few years is any indication, it is clear that government influence on the rules for competition and prudential regulation of the financial sector is rather substantial.

Governments, unfortunately, are run by a set of individuals who by and large are myopic, unlike the normative prudential regulators in our theoretical models, who are fully benevolent and maximize the long-run welfare of the global
economy. The implications of government myopia for financial sector risk-taking deserve our careful scrutiny.

There are several forces that give rise to government myopia.

First and foremost, governments are focused on getting re-elected. Hence, they may cater to specific constituencies or to preferences of the current – that is, the voting – generation. Such catering can take the form of boosting current economic activity and jobs, or offering excessive and exorbitant health care and pension benefits, even if such stimulus risks grave financial hazards for the non-voting constituencies or future generations.

Second, government balance-sheets are hard to comprehend since they inherently involve inter-temporal smoothing of expenditures and taxation. Given this difficulty of comprehension, current growth and economic statistics drive the evaluation of a government’s success by the population. In turn, even long-term governments and politicians can find themselves at times to be trapped in the game of meeting short-term expectations. They may do so by signal-jamming into current spending and activity, and due to the unavoidable “noise” in realized economic outcomes, the true risks of government decisions may become known only after a substantially long period of filtering of these outcomes.

Since the financial sector can directly affect the scale of investment and production in an economy, it becomes a convenient device whose leverage and risk-taking myopic governments wish to control. Governments may adopt policies that create excessive current intermediation – for instance, aim for an excessively “large financial center” – at the expense of future costs of financial instability. Short-run governments can deregulate the financial sector and erode franchise
values, provide downside guarantees to create further entry, weaken risk controls and capital requirements, subsidize leverage through tax deductions, and direct lending to specific sectors (“priority sector norms”) or constituencies (“affordable housing”) for populist goals.

Through these means, governments effectively operate as “shadow banks” in the financial sector, exploiting intermediation activity for private objective, the end result of which is the fueling of credit booms and periods of intense economic activity, but with a looming threat to financial stability in the long run. Prime examples of such risks include the long-run risk of unbudgeted housing subsidies, funding risks from underpaid health-care and unemployment protection for the current generation, and large and unsustainable fiscal deficits. Many of these policies – and their welfare costs – have come to surface following the housing, public finance and sovereign debt crises in the Western economies since 2007.

Somewhat paradoxically thus, government moral hazard manifesting as short-term regulatory policies for the financial sector, can in fact be a bigger risk to financial stability than the purely private leverage- and risk-taking incentives of the financial sector. A natural conclusion of this – arguably cynical – view of government decision-making is that “tail risks” and the regular incidence of crises in the financial sector are structurally induced by political economy forces.

I believe therefore that in times such as we are in right now, when there is some, even if fragile, consensus for designing financial architecture and prudential regulation for the long run, that the independence of central banks and prudential rule-making bodies must be exercised fiercely. We, as academics, need to devote far greater resource and intellectual capital to deepening our
understanding of public finance and programs, and provide a transparent communication in published work or in media of any hidden tail risks of these programs.

I conjecture that going forward we are likely to find more relevant studying the nature of government balance-sheets and their risks. Conversely, focusing attention merely on the private financial sector and its market failures would be an incomplete economic exercise if we do not at the same time pay adequate attention to government failures in the efficient implementation of remedies that our analysis may suggest for addressing in the long run the market failures of the private financial sector.