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Do We Need the Government to Run a Good Financial System?

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Government/Banking Nexus

- Four pillars of traditional financial intermediation:
  - loans
  - deposits
  - DI and LOLR
  - prudential supervision/regulation
- Financial system as pubic-private partnership
- Feature or bug?

Normative Mechanism Design Approach

- Normative mechanism design approach to financial system
- Market failures and 2nd best constrained efficiency
- Perspective with far-ranging implications in different contexts:
  - destabilizing effects of shadow banking
  - architecture of IMS
  - doom loops and design of banking unions
  - ...
- Branch out of organizing framework of Farhi-Tirole (17)

Deep Relation to Diamond and Kiyotaki-Moore

- Approach:
  - microfoundations
  - mechanism design
- Ideas:
  - banks as delegated monitors, securities holders, and deposit takers, with agency problems in Diamond (1984)
  - deposit insurance to prevent runs in Diamond-Dybvig (1983)
  - interaction inside/outside money in Kiyotaki-Moore (2018)

LOLR and Deposit Insurance as Outside Liquidity

- LOLR and DI as outside liquidity:
  - ex-ante priced insurance against ex-post tail risk
  - different from ex-post bailouts
- Alleviate aggregate inside liquidity shortages
  (limited pledgeability, runs/incomplete markets/aggregate risk)
- Government comparative advantage from unique fiscal powers
  (Holmstrom-Tirole 1998)

Two Complementarities

- Complementarities via fiscal externalities from moral hazard:
  - LOLR and supervision/regulation
  - DI and supervision/regulation
- Economies of scope in supervision/regulation
- Other rationales for supervision/regulation:
  - (non-systemic) protection and representation of consumers
  - (systemic) pecuniary externalities (fire sales) and aggregate demand externalities (Keynesian), see Farhi-Werning (2016) for unified theory

Shadow Banking

- Option to migrate to shadow banking
- No LOLR, no DI, no supervision/regulation
- Ex-ante moral hazard and ex-post bailouts
  (limited commitment of government)

Interrelations Banking/Shadow Banking

- Many interrelations banking/shadow banking
- Liquidity/risk sharing and provision
- Alternative strategy to back safe/liquid deposits: liquid assets sold to regulated banks in case of "runs", leading to "fire sales" (Hanson-Shleifer-Stein-Vishny 15)

Destabilizing Effects of Shadow Banking

- Participation/incentive constraint ... rents to regulated banks
- Liquidity syphoning and bogus liquidity ... structural remedies (ring-fencing and CCPs)
- Runs, pecuniary and aggregate demand externalities (Shleifer-Vishny 92, Lorenzoni 08, Stein 12, Farhi-Werning 16, Davila-Korinek 17,...)
- Fiscal externalities, (collective) moral hazard and (systemic) bailouts (Farhi-Tirole 12)
- Extend domain of regulation to shadow banking?
- Also benefits: competition, innovation, yardstick ...

Governments as Bankers and the IMS

- Reserve countries as banks supplying safe assets to RoW
- Few large issuers, monopoly (US) or duopoly (US + UK in 20s, US + China in future?)
- Farhi-Maggiori (2018): model of IMS combining financial intermediation theory + IO imperfect competition + international macroeconomics

Bretton Woods and Triffin Dilemma

- Increased demand for reserve assets under Bretton Woods
- Two opposing views:
  - Triffin dilemma (61)
  - "world banker" view of Despres-Kindleberger-Salant (66)
- World banking is fragile: self-fulfilling runs ... shift monetary to fiscal dominance ... devaluation ... loss of reputation
- Even with flexible exchange rates and large private capital flows ... new Triffin dilemma
  (Farhi-Gourinchas-Rey 11, Obstfeld 11, Farhi-Maggiori 18)

New Triffin Dilemma and Architecture of IMS

- World banking fragile ... new Triffin dillemma (no LOLR/DI for reserve issuers)
- Safe asset shortage, high risk premia, low interest rates, ZLB (no outside liquidity)
- Monopolist world banker might over-issue and risk crisis (no regulator)
- Instability from multipolar vs. unipolar by exacerbation of coordination problems (Nurkse 1944) and loss of discipline from erosion of franchise value despite benefits of competition (US+UK in 20s, US + UK in future?)
- International risk sharing and LOLR to reduce demand for safe assets (IMF, central bank swap lines)?
- Future of IMS? Special role of the dollar?

Conclusion

- Normative mechanism design approach to financial system
- Theory of government/banking nexus: features and bugs
- Far-ranging implications in different contexts:
  - destabilizing effects of shadow banking
  - architecture of IMS
  - doom loops and design of banking unions (Farhi-Tirole 17)
  - ...