CENTRO DE ECONOMÍA APLICADA

Abstract

Bailout policy is time-inconsistent, which results in multiple equilibria characterized by over-leverage, high risk correlation and little liquidity holding. A long-run horizon allows the authority to define bailouts plans that rule out bad equilibria, as opposed to supporting superior policies as time-consistent. As in most applications I use this framework to discuss the effectiveness of three prudential policy proposals: too-big-to-fail size caps, taxes on borrowing and liquidity requirements. I also argue that policies alleviating the time-inconsistency of bailouts may generate large welfare gains and discuss three alternatives: policies against the scarcity of liquidity during crises, bailouts design, and public debt.