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## Bailouts and Financial Fragility Get access >

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The Review of Economic Studies, Volume 83, Issue 2, April 2016, Pages 704–736, https://doi.org/10.1093/restud/rdv044

**Published:** 29 October 2015 Article history ▼

#### **Abstract**

Should policy makers be prevented from bailing out investors in the event of a crisis? I study this question in a model of financial intermediation with limited commitment. When a crisis occurs, the policy maker will respond with fiscal transfers that partially cover intermediaries' losses. The anticipation of this bailout distorts ex ante incentives, leading intermediaries to become excessively illiquid and increasing financial fragility. Prohibiting bailouts is not necessarily desirable, however: while it induces intermediaries to become more liquid, it may nevertheless lower welfare and leave the economy more susceptible to a crisis. A policy of taxing short-term liabilities, in contrast, can both improve the allocation of resources and promote financial stability.

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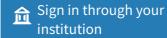
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