

Bailouts and Financial Fragility

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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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