Accepted Manuscript

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PII: S1386-4181(17)30034-4
DOI: 10.1016/j.finmar.2018.01.003
Reference: FINMAR 458

To appear in: *Journal of Financial Markets*

Received Date: 3 February 2017
Revised Date: 22 January 2018
Accepted Date: 23 January 2018

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Abstract

We model the effect of bank bailouts on portfolio choices and welfare. Banks sell bonds to leverage investment in risky projects and households buy bonds under rational expectations about default risk. Bailouts induce greater leverage but reduce equilibrium interest rates. The interest rate effect dominates the leverage effect and bailouts lead to fewer bank failures. Bailouts are efficient but not Pareto optimal: bailouts increase social welfare by mitigating uninsurable risk, which helps banks but hurts households since the insurance gains are not worth the price households must pay to finance the bailout.

*We would especially like to thank an anonymous referee for providing suggestions that have greatly improved the paper. We also thank Ben Blau, Aspen Gorry, Bill Shughart and seminar participants at Utah State University, BYU-USU macro workshop, Southwest Finance Association Conference, IFABS Asia Ningbo China Conference, and West Virginia University for helpful comments.

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