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Policy uncertainty and bank bailouts*

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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.

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