Bail-Ins vs. Bail-Outs
Some Theoretical Considerations

Emmanuel Farhi

Chicago Fed, 2016

Roadmap

- 2nd-best theories of debt
- Externalities
- Corrective interventions (“theory” of bail-ins)
- Monitoring and regulatory burden
- Bail-ins vs. bail-outs
- Important practical issues

2nd-Best Theories of Debt

- Agency
- Control rights
- Information/signaling
- Taxes

Case for Gov. Intervention?

- Agency
- Control rights
- Information/signaling
- Taxes

- Overall, 2nd best theories: no strong case for gov. intervention
- Externalities?

Market Failures: Micro and Macro Externalities

- Fiscal externalities (bail-outs)
- Pecuniary externalities (fire-sales)
- Aggregate demand externalities

- Market failure: private vs. social
- Not enough state-contingent (bail-in-able) debt

Pigouvian Corrective Interventions

- Market failure: private vs. social
- Not enough state-contingent (bail-in-able) debt
- Pigouvian corrective intervention needed:
  - price or quantity regulation
  - micro vs. macro triggers

Monitoring and Regulatory Burden

- Hard debt or runnable debt to monitor/discipline managers
- Bail-ins increase creditor incentives to monitor
- Alleviate free-rider problem in monitoring
- Ease regulatory burden (representation hypothesis)

Bail-Ins vs. Bail-Outs

- Bail-ins reduce need for bail-outs
- Go all the way?
- Hard to cleanly separate bail-outs vs. LOLR/liquidity provision
- Strong case for latter
- Bail-ins AND bail-outs, not bail-ins VS. bail-outs

Important Practical Issues

- "Lucas critique"...
- Substitution bail-in-able vs. not securities
- Concentration of risk in systemic financial institutions
- International ramifications