

Government Bailout Policy:
Transparency vs. Constructive Ambiguity¹

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September 5, 2008

Work-in-Progress

Abstract

Major financial institutions and corporations are often offered capital support when they are in financial distress. While such support could avoid economy-wide systematic damages, it also contributes to a moral hazard problem. This paper discusses the optimal bailout policy where these two factors are considered. We find that the optimal bailout policy takes different forms: it calls for a guaranteed bailout for big institutions (“Too Big to Fail”), a randomized bailout for medium sized institutions (“Constructive Ambiguity”), and no bailout for small ones. A transparent, guaranteed bailout needs to be accompanied by ex post monitoring (auditing) and penalty. However, in a volatile, innovative market environment where the individual institutions know more than the government regulator, monitoring error could contribute to risk-taking and the government regulator will always play a catch-up role in revising policy. The optimal bailout policy may not be time-consistent: institutions not deemed “too big to fail” may still take excessive risks and expect to be bailed out in case of insolvency. The time inconsistency problem mainly comes from the short-term orientation of the government. Finally, as an institution’s systematic risk affects the probability of bailout, the boundary of a firm may be extended by the government subsidy.

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