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TIME CONSISTENT OPTIMAL FINANCE OF BAILOUTS: FISCAL POLICY VERSUS MONETARY POLICY

(Job Market Paper)

This paper studies the optimal way to finance bailouts given the currency composition of external debt. Motivated by the recently growing domestic currency share of external government debt in the developing world, the paper proposes that bailouts can be financed by debt dilution through domestic currency depreciation together with tax revenue.

I develop a dynamic stochastic general equilibrium model to study the optimal time consistent finance of bailouts under nominal and financial frictions. Binding external borrowing and domestic equity market constraints prevent the production sector from financing the desired level of investment. Households are not willing to transfer funds to the production sector during a tight credit regime, since they do not recognize that future benefits outweigh contemporaneous costs. However, a policymaker can extract resources from households and/or international lenders to alleviate the under-capitalization of the production sector.

I first consider the case where the policymaker can only collect income taxes from households to finance bailouts and government expenditure. The policymaker also finds it optimal to increase government spending when both constraints bind, since this policy increases the relative price of non-tradables and thereby relaxes the financial constraint. I find that bailouts allow for a quicker recovery than government expenditure during a tight credit regime.

I then extend the basic setup by introducing long-term government debt denominated in domestic currency and held by risk-neutral foreign lenders. The policymaker can now finance bailouts both through income taxes and through an inflation tax that reduces the real value of its nominal liabilities to foreign lenders. The policymaker trades off the benefits and costs of the inflation tax. The cost includes distortionary effects on labor demand as well as higher real external debt of the private sector as the exchange rate depreciates faster than prices rise. The quantitative analysis shows that to alleviate the under-capitalization of the production sector, the policymaker is more inclined to impose an inflation tax on international lenders than to collect income taxes from households. Adding the inflation tax as a policy tool significantly raises welfare gains.

Keywords: Bailouts, Time Consistency, Currency Mismatch, Debt Dilution, Capital Controls

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