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CONTAGION, BAILOUTS AND WELFARE IMPACTS OF SYSTEMIC RISK

Abstract:

The aim of the paper is to study whether a private-sector bailout can emerge endogenously, when agents act rationally in the absence of a government intervention. I study a contagion model in which may prevent default cascades by bailing out defaulted. Using this model, I derive the conditions for social efficiency and individual rationality of bailouts. Bailouts are almost always socially efficient but hardly ever individually rational because of an interesting feature of contagion effects. There exists a solution that is both individually rational and socially efficient. However, it does not constitute a non-cooperative equilibrium. I conclude that a policy intervention in which are forced to contribute an amount proportional to the contagion losses received towards a bailout can provide a solution to this dilemma.

Keywords:

Systemic Risk; Financial Stability; Financial regulation

JEL Classification: G00, G01, G18