

Reputation, Bailouts, and Interest Rate Spread Dynamics

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Abstract

This paper develops a theory of interest rate spread dynamics driven by fundamentals and the expectations of future bailouts. A government can be either a commitment type that never bails out or a no-commitment type that can sequentially decide whether to bail out lenders or not. Borrowers and lenders do not know the type of the government and learn about it over time by observing the government's actions. We show that there exists a Markov equilibrium in which in normal times, the static costs of not bailing out are small and there is no bailout. Once fundamentals start to deteriorate, it is optimal for the no-commitment type to randomize between bailing out and not. Conditional on observing no-bailout, private agents assign a lower probability to future bailouts, which in turn leads to an increase in spreads and contagion to borrowers not directly hit by the shock. If the crisis becomes more severe, the static incentives to bailout become too large and the no-commitment type bails out. Private agents then anticipate future bailouts with higher probability and spreads for all borrowers decrease despite the crisis being more severe. These dynamics are consistent with the behavior of spreads during the recent European debt crisis and the US financial crisis around the failure of Lehman Brothers.