“Dueling policies” – Separating Equilibrium

Regulator’s type:
Tough/Intermediate/Weak.

Stage 1 (Fraction of Banks’ choices)
- Highly correlated banks
- Uncorrelated banks

Stage 2 (Returns materialize)
- Financially distressed banks
- Profitable banks

Stage 3 (Bailout policy)
- Bailouts unlikely
- Bailouts most likely

Nature draws regulator’s type (tough): “Almost not inclined to bail out banks”.

Regulator sets a **low tax**, because it is unlikely banks coordinate on bailout prospects. Banks form a low posterior probability about receiving bailout support. Most banks are convinced they deal with a “tough” regulator due to their private information.

Regulator’s type (intermediate): “Not really inclined to bail out banks”.

Regulator sets a **high tax**, to distinguish credibly from the “weak” type below. No banks coordinate, because the tax discourages effectively. However, because of the higher tax, the regulator distorts the markets and incurs the cost of the tax.

Regulator’s type (weak): “Highly inclined to bail out banks”.

Regulator sets a **low tax**, to imitate the tough regulator. Most banks’ private information reveals a weak regulator. However, banks cannot distinguish between The “tough” and “weak” regulator: **constructive ambiguity**.

More banks, possibly all, will coordinate if they do not observe a low or high tax.