Soft budget constraints in a dynamic general equilibrium model

Seminarios y talleres

This paper considers an overlapping generations model in which capital investment is financed in a credit market with adverse selection. Lenders' inability to commit ex-ante not to bailout ex-post, together with a wealthy position of entrepreneurs gives rise to the soft budget constraint syndrome, i. e. the absence of liquidation of poor performing firms on a regular basis. This problem arises endogenously as a result of the interaction between the economic behavior of agents, without relying on political economy explanations. We found the problem more binding along the business cycle, providing an explanation to creditors leniency during booms in some LatinAmerican countries in the late seventies and early nineties.

- Print