

Abstract: We examine lean versus clean in a rational-bubble model. Over-speculation in asset bubbles is more likely to occur if the quality of the financial system is relatively high. Contrary to the conventional view, we show that macro-prudential regulation against bubble may end up increasing bubbly boom-bust cycles, while expectations about government's bailouts after the collapse of bubbles dampen bubbly boom-bust cycles. However, from a welfare perspective, macro-prudential regulation is of first-order importance for taxpayers (workers who are non-bubble holders). Under some conditions, the optimal policy for taxpayers is a combination of macro-prudential regulation against bubble with government's partial bailouts after the collapse of bubbles, irrespective of whether government can commit to future bailout policy. This finding provides a theoretical foundation of the case for leaning against bubble policy as well as for clean up policy after the collapse of bubbles. By contrast, for entrepreneurs rescued by government (bubble-holders), macro-prudential regulation is welfare-reducing, while bailout policy is welfare-improving. These results suggest that if government favors bubble-holders (wall-street people), bailout policy is more likely to be undertaken, and as a result, a large bubble is created, which results in increasing inequality between taxpayers and bubble-holders.