

The Problem of Bad Debts: Cleaning Banks' Balance Sheets in Economies in Transition

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Abstract

Many countries, including economies in transition, have suffered banking crises in recent years. This paper develops a general framework for analysing trade-offs between policies for cleaning banks' balance sheets of bad debt. The framework - a two-tier hierarchy consisting of regulators, banks, and firms - is applied to analyse three types of policies that have been advocated or employed in the economies in transition. Hidden information and moral hazard are present at each tier of the hierarchy. The analysis identifies two types of effects of policy choice: a direct effect of the policy on bank behaviour and an indirect effect on firm behaviour as a reaction to the bank response. Both effects are important determinants of policy trade-offs. The analysis demonstrates that differing policies applied to financially distressed banks have differing real effects on firms' and banks' asset values, even when all firms and banks are state-owned.

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