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The Debt-Equity Ratio of Firms and the Effectiveness of Interest Rate Policy: Analysis with a Dynamic Model of Saving, Investment, and Growth in Korea

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V. Sundararajan

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Abstract

The paper analyzes empirically the linkages between interest rates, the debt-equity ratio of firms, the overall cost of capital, saving, investment, and growth in the Korean economy during 1963-81. The interdependence between financing and real decisions is explicitly modeled. Estimates show that the overall cost of capital is U-shaped, first falling and then rising as the debt-equity ratio rises, and this relationship has far-reaching implications for the effectiveness of interest rate policy. In particular, model simulations reveal that in recent years, owing to high corporate debt, the effectiveness of interest rate policy has been substantially weakened.

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