



Holding out for a haircut: financial crisis, moral hazard, and interest rate policy

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Abstract

The International Monetary Fund (IMF)-prescribed introduction of higher interest rates in crisis-hit economies has been criticized as being unnecessarily contractionary. This criticism ignores the effects of interest rate policy on the incentives to restructure corporate debt once it has become strategically optimal for domestic firms to declare a state of over-indebtedness. A widespread state of debt moratoria constitutes a 'bad' equilibrium, whereas the widespread adoption of a quick debt workout strategy is a potentially 'good' equilibrium. The latter can be encouraged through various policies, most controversially a short-term policy of high interest rates. Other potential policies include: (i) widespread debt forgiveness; (ii) enhanced implementation of the bankruptcy court; and (iii) the enforcement of free market competition. Copyright © 2000 John Wiley & Sons, Ltd.

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