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**MORAL HAZARD IN FINANCIAL MARKETS:
INEFFICIENT EQUILIBRIA AND MONETARY POLICIES**

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Abstract

This paper presents a moral hazard model of financing in which borrowers adopt two modes of finance, either issuing bonds or applying for bank loans. The bond rate is set by the borrowers, while the loan rate is chosen by a monopolistic bank. Bank finance ameliorates the moral hazard problem by monitoring borrowers. Monetary interventions, which affect real economy through the bank lending channel, are justified on the basis of welfare considerations. When the informational problem is not severe, monitoring is wasteful and welfare is enhanced through a monetary tightening. When the moral hazard problem is severe, monitoring is useful and welfare is increased by a monetary expansion.

Keywords: moral hazard, monitoring, monetary policies, bank lending channel.

JEL Classification: D82, E44, E52.

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