Collateral and Punishment: A Tale of Two Contracts

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Abstract

This paper builds a binomial general equilibrium model where both secured and unsecured debt contracts are available for trade and analyzes this model to prove the existence and determine the nature of equilibria. In particular, I define a coexistence equilibrium in this economy as an equilibrium that involves trade in at least one asset of each type and study the conditions sufficient to guarantee its existence. This paper combines endogenous leverage with the anonymity of perfectly competitive markets to present a scenario where agents choose to hold two different kinds of debt. I connect this behavior to endowment inequalities that prevent some agents from being able to afford the down payment necessary to access secured credit, and explore how this affects agents’ portfolio decisions between the two types of debt. Finally, by comparing equilibria across financial structures where only one or both kinds of contracts are available, I also explore the asset pricing and redistributive implications of these results, especially in a world where such inequalities exist.

Keywords: Incomplete Markets, Collateral, Unsecured Debt, Asset Pricing

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