Secured Loan as Collateral and Unsecured Loan in the Financial Activities of an Entrepreneur

Yasunobu Tomoda [a], Makoto Okamura [b]
[a] Japan Society for the Promotion of Science,
Institute of Economic Research, Kyoto University,
Yoshida-Honmachi, Sakyo-ku, Kyoto 606-8501, Japan
[b] Faculty of Economics, Hiroshima University,
Kagamiyama 1-2-1, higashihiroshima-shi, 739-8525, Japan

Abstract

This paper considers en entrepreneur who potentially sets up a monopolistic firm but faces the risk of demand shock. The entrepreneur has two possible financial choices: he can use the capital good component of his production as collateral for a low interest secured loan or he can obtain funds through an unsecured loan that does not require collateral but charges a high interest rate. Through his cost minimization problem, the choice of financial contracts changes the marginal costs of the production and inputs of product factors. Therefore, financial loans significantly affect the output market and sometimes hurt the social welfare.

Keywords: Borrowing constraint; Collateral;
JEL Classifications: G21; G31; L12