Preliminary

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Default Risks and Collateral in the Absence of Commitment in a Two-country Model

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Abstract

We extend a model by Mills and Reed (2012), which studies both the incentive role and the insurance role of collateral in an optimal contract model that looks like a repurchase agreement contract, into a two-country model. In extending their model, we assume that some domestic agents want to purchase goods in the foreign country in exchange for foreign fiat money in their second period of lives, and thus they trade their domestic fiat money for foreign agents' foreign fiat money. We further assume that foreign exchange rates vary within a period because the number of agents shows up in the foreign exchange market varies within a period. Therefore, even if the agents participate in the foreign exchange transactions with the same units of domestic fiat money, they could obtain different units of foreign fiat money and could consume different amount of foreign goods. If we assume some agents that can commit their actions, several policy tools, such as foreign exchange interventions, to limit the variation of foreign exchange rates within a period could smooth the level of consumption for foreign goods irrespective of the timing of foreign exchange transactions and could improve the ex-ante utility of agents.

Key words: collateral, contract, repurchase agreement, foreign exchange

JEL Classification: E44, E58, F31

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