A Model of Collateral*

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Abstract

This paper presents a simple equilibrium model in which collateralized credit emerges endogenously. Just like in repos, individuals cannot commit to the use of collateral as a guarantee of repayment, and both lenders and borrowers have incentives to renege. Our theory provides a micro-foundation to justify the borrowing constraints that are widely used in the existing macroeconomic models. We explain why assets are often used as collateral, rather than as a means of payment, why there is a tradeoff in assets between return and liquidity, and what kinds of assets are useful as collateral.

Keywords: collateral; search; medium of exchange; voluntary separable repeated game

JEL Classification Numbers: C73, E30, E50

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