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Article

A Rational Expectations Model of Financial Contagion

Laura E. Kodres, Matthew Pritsker

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ABSTRACT

We develop a multiple asset rational expectations model of asset prices to explain financial market contagion. Although the model allows contagion through several channels, our focus is on contagion through cross-market rebalancing. Through this channel, investors transmit idiosyncratic shocks from one market to others by adjusting their portfolios' exposures to shared macroeconomic risks. The pattern and severity of financial contagion depends on markets' sensitivities to shared macroeconomic risk factors, and on the amount of information asymmetry in each market. The model can generate contagion in the absence of news, as well as between markets that do not directly share macroeconomic risks.

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