Financial Entanglement: A Theory of Incomplete Integration, Leverage, Crashes, and Contagion*

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Abstract

We propose a unified model of limited market integration, asset-price determination, leveraging, and contagion. Investors and firms are located on a circle, and access to markets involves participation costs that increase with distance. Despite the ex-ante symmetry of investors, their strategies may (endogenously) exhibit diversity, with some investors in each location following high-leverage, high-participation, and high-cost strategies and some unleveraged, low-participation, and low-cost strategies. The capital allocated to high-leverage strategies may be vulnerable even to small changes in market-access costs, which can lead to discontinuous price drops, de-leveraging, and portfolio-flow reversals. Moreover, the market is subject to contagion, in that an adverse shock to investors at a subset of locations affects prices everywhere.

Keywords: Financial frictions, Market fragmentation, Leverage, Crashes, Contagion

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