Financial contagion in a two-country model

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Abstract

I study a two-country version of the banking model with financial markets developed in Allen and Gale (2004). Similar to their model, two types of banks arise endogenously in an autarkic economy: some always remain solvent and others can default. When the financial markets are integrated, three types of banks can arise endogenously, and some banks go bankrupt because of the liquidity shocks of the other country. I show that financial market globalization can cause financial contagion and reduce welfare. In addition, I show that endogenous inequality across countries can be observed: a financial system of one country is more fragile than that of the other country.

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