“Financially Constrained Arbitrage and Cross-Market Contagion”

Denis Gromb
From
INSEAD

יום שני, 30 במרץ 2015, בשעה 14:00
סמינרון 110, בניין אדר-שטר, קמפוס המרכז הבינתחומי, הרצליה

Abstract

We propose a continuous time infinite horizon equilibrium model of financial markets in which arbitrageurs have multiple valuable investment opportunities but face financial constraints. The investment opportunities, heterogeneous along different dimensions, are provided by pairs of similar assets trading at different prices in segmented markets. By exploiting these opportunities, arbitrageurs alleviate the segmentation of markets, providing liquidity to other investors by intermediating their trades. We characterize the arbitrageurs’ optimal investment policy, and derive implications for market liquidity and asset prices. We show that liquidity is smallest, volatility is largest, correlations between asset pairs with uncorrelated fundamentals are largest, and correlations between asset pairs with highly correlated fundamentals are smallest for intermediate levels of arbitrageur wealth.