Vanishing Contagion Spreads

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Abstract

We study default in a multi-firm equilibrium setting with incomplete information. Defaults are modeled to be consistent with the firm's balance sheet and aggregation over firms. Market prices and quantities of risk are derived in closed form. If the number of firms increases, the market prices of risk converge to a well-defined limit while the endogenous volatility and jump size of debt and equity generated by other firms' shocks vanish, so that credit spreads depend asymptotically only on the firms' own cash flow risk. This novel contagion result calls into question recent results based on production economies, where quantities of risk are specified exogenously, that attribute credit spreads mostly to contagion.

Keywords: Credit Spreads, Contagion, Exchange Economy, Equilibrium, Incomplete information, Risk Premia Representation.
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