

Contagion in Experimental Financial Markets *

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Abstract

We experimentally study the possibility that news of a crisis in one market may cause a contagious crisis in another market though there are no links between those markets. Literature provides models of contagion in which news of a crisis may cause contagion in Bandwagon and Strategic risk channels; however, these models lack empirical evidence. The reason may be that it is difficult to isolate the effect of news of a crisis in real data, as markets are linked in many ways. To our knowledge this is the first research into contagious effects of the news of a crisis. We modify the influential experimental design of Smith et al. (1988) to construct an environment in which two separate markets are traded simultaneously, and there is no link between these markets other than possibility of observing prices in the other market. We create a crisis in one market by simulating a price drop in that market and observe whether prices in the other market drop in a contagious manner. Our results show that news of a crisis is a significant source of contagion and the Bandwagon channel is significant, while the Strategic risk channel is not. Further, news of a crisis may cause contagion in channels other than Bandwagon and Strategic risk; however, we do not identify which channels in the present study, leaving it for future research.

JEL classification: C92, G12,

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