

## **Abstract**

Financial contagion is modeled as an equilibrium phenomenon. Because liquidity preference shocks are imperfectly correlated across regions, banks hold inter-regional claims on other banks to provide insurance against liquidity preference shocks. When there is no aggregate uncertainty, the first-best allocation of risk sharing can be achieved. However, this arrangement is financially fragile. A small liquidity preference shock in one region can spread by contagion throughout the economy. The possibility of contagion depends strongly on the completeness of the structure of interregional claims. Complete claims structures are shown to be more robust than incomplete structures.