Academic Panel

“Financial integration and stability: the legacy of the crisis”

Marco Pagano
Università di Napoli Federico II

ECB and EU Commission Conference
12 April 2010

Dark side of financial development and integration

- Recent evidence on financial development:
  - Kroszner, Laeven and Klingebiel (JF 2007): in banking crises, FD amplifies contraction of more externally dependent industries
- Recent evidence on financial integration:
  - Degryse, Elahi and Penas (2009): using cross-border exposures of 17 countries from 1999-2006 BIS data, find that (i) contagion from one country can easily destabilize entire financial system and (ii) speed of propagation of contagion has increased in recent years
  - Puri, Rocholl and Steffen (2009): losses on US toxic assets have reduced loan supply to German firms during crisis
  - Popov and Udell (2010): losses on US toxic assets have reduced loan supply to Central and Eastern European firms

Not too surprising: think about why we like living in big cities…

- Positive externalities from agglomeration:
  - Diversity of trading opportunities: as consumers, more variety of goods and services to buy; as producers, more variety of intermediate inputs and labor skills, and of clienteles to cater to.
  - Economies of scale and benefits from division of labor (Adam Smith's insight).
- Negative externalities from agglomeration:
  - Congestion and pollution.
  - Possible contagion from infectious diseases.
- YET, contagion risk has not deterred city growth: offset by
  - better sanitation and vaccines (ex ante)
  - better ways to contain contagion: hospital, cures (ex post)

Similarity with financial integration – but only up to a point

- Positive externalities:
  - Greater diversification: can hold more diversified portfolios as investors and financial intermediaries.
  - Greater liquidity: easier to find a trading counterparty.
- Negative externality:
  - More diversified portfolios $\Rightarrow$ losses on an assets affect the balance sheets of a larger number of investors.
  - More promiscuous trading $\Rightarrow$ bankruptcy of one intermediary affects more market participants.
- Yet, important difference with infectious diseases: diversification increases *exposure* to “disease” but reduces *severity* of disease if you catch it.

Two types of financial contagion

Precisely for this reason, diversification does not necessarily raise the severity of financial contagion:

- In the crisis, contagion was partly due to **too limited or ineffective diversification**:
  - losses affecting entire classes of assets (RMBS, housing)
  - banks overexposed to certain risks or firms in a given country borrowing from a few banks (e.g., Swedish banks in Baltic states).
- Diversification raised contagion insofar as it combined with such **extreme asymmetric information** as to induce **trading freeze** in some markets, due to counterparty risk:
  - e.g., diversification of money market funds into Lehman's commercial paper $\Rightarrow$ money market freeze after Lehman's bankruptcy.

How to limit financial contagion?

- Type-1 contagion (too little diversification): avoid
  - overexposure of banks to certain classes of risks or adjust capital requirements accordingly.
  - overdependence of borrowers on a few lenders.
- Type-2 contagion (diversification joint with freeze):
  - Ex ante (sanitation): transparency about market participants' liabilities, and price counterparty risk accordingly.
  - Ex post (cures):
    1. Liquidity provision.
    2. Emergency provision of bank capital / bailouts.
    3. Orderly insolvency procedures.
- ECB did well on 1. **BUT EU is still unprepared on 2 and 3 as far as pan-European banks are concerned.**