Discussion of
"EMU and Financial Integration" by P. Lane
and
"Financial Integration and Risk Sharing: The Role of the Monetary Union"
by S. Kalemli-Ozcan, S. Manganelli, E. Papaiannou & J. L. Peydrò (KOMPP)

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The papers

- Very well written, complete and up-to-date in their assessment of the literature.
- Surprising how many good studies on the topic, especially in 2007 and 2008. I learnt a lot!
- Two parts in each paper:
  - description of the evolution of various markets upon the inception of EMU and concomitant reforms (FSAP, TARGET, etc.),
  - novel part on the effects of EMU on financial integration, and of both on the real economy.

I will focus on this

New finding # 1: bank integration

- Previous work: EMU has been associated with greater integration in money, bond and stock markets, but we know much less about the integration of banks.
- KOMPP measure integration of banks using BIS data on banks' bilateral cross-border holdings.
- Panel structure allows them to control for fixed country and country-pair effects. They find that bank integration is associated with:
  - **EMU**,
  - **financial reform** – independent effect. New finding!

New finding # 2: risk sharing

- Here we enter realm of the “real effects” of EMU and financial integration (which also becomes an explanatory variable).
- Past literature focused on “growth dividend” of EMU via financial integration and development.
- Much less effort directed to explore if EMU is also associated improved risk sharing.
- But both Lane and KOMPP probe further into **macro-level evidence** on this score.

Two variants of same approach

- **Basic idea** is common: differences in consumption growth among pairs of countries should not be related to the respective difference in income growth.

$$\Delta \log c_{it} - \Delta \log c_{jt} = \phi_{ij} + \delta_t + \beta(\Delta \log y_{it} - \Delta \log y_{jt})$$

- **Lane**: does β decrease over time, and more for **EMU country pairs** than for non-EMU ones? Not really, if sample is extended to 2006.
- **KOMPP**: does β decrease more for country pairs with **more cross-border bank assets and/or liabilities**? Yes, for assets. No, for liabilities (“desmoothing”). Notice: they do not use EMU as explanatory variable.

Possible reading of evidence

- **No detectable effect of EMU on risk sharing** in macro data. (BTW, consistent with Jappelli and Pistaferri (2008) on micro data for Italy.)
- Evidence points to **effect of financial integration on risk sharing** in a larger set of 20 countries. But:
  - not specifically connected with EMU;
  - "desmoothing effect" of cross-border liabilities may reflect episodes of "binge borrowing" arising from financial liberalization (including low interest rates upon entry in EMU: Spain, Ireland, etc.).
- Probably **too early** to expect detectable EMU-induced increases in risk sharing: effects of such a large regime change likely to cloud steady-state regularities!

Risk sharing and the crisis

- Perhaps the **crisis** is just an "**instance of massive risk sharing**", with Europe sharing the burden of the "negative shock" in the US.
- But **not a "shock" as normally defined** in our models (news about productivity or tastes). It is a massive malfunctioning of markets. So, better risk sharing may mean also sharing more in such malfunctionings!
- Lane (p. 16): by facilitating financial integration, **EMU may have strengthened "contagion"** (perhaps less integrated banks would have bought fewer CDOs…)
- **But** EMU **also prevented** it from turning into a **currency crisis**: in this sense, it has also been a powerful stabilizer (Lane, p. 25). Just consider the plight of "New Europe"!

Key lesson for EMU’s future

- The crisis has **painfully exposed the unfinished state of the institutions of EU financial markets**: see initially uncoordinated response to bank solvency problems.
- It tarnished two “success stories” of European integration:
  - vibrant euro-area corporate bond market,
  - emergence of a few large pan-European banks.
- In the current “middle station” the benefits of integration are at serious risk: **for large pan-European banks, EMU badly needs to be complemented by coordinated supervision and crisis management**.
- Politically thorny regulatory and fiscal implications. But hopefully the crisis convinced us to face up to them!