Abstract
This paper compares four forms of inter-regional financial risk sharing: (i) segmentation, (ii) integration trough the secured interbank market, (ii) integration trough the unsecured interbank market, (iv) integration of retail markets. The secured interbank market is an optimal risk-sharing device when banks report liquidity needs truthfully. It allows diversification without the risk of crossregional financial contagion. However, free-riding on the liquidity provision in this market restrains the achievable risk-sharing as the number of integrated regions increases. In too large an area this moral hazard problem becomes so severe that either unsecured interbank lending or, ultimately, the penetration of retail markets is preferable. Even though this deeper financial integration entails the risk of contagion it may be beneficial for large economic areas, because it can implement an efficient sharing of idiosyncratic regional shocks. Therefore, the enlargement of a monetary union, for example, extending the common interbank market might increase the benefits of also integrating retail banking markets through cross-border transactions or bank mergers. We discuss these results in the context of the ongoing debate on European financial integration and the removal of bank branching restrictions in the United States happening primarily during the 1980s and early 1990s, and we derive implications for the relationship between financial integration and financial stability. Last we illustrate the scope for cross-regional risk sharing with data on non-performing loans for the European Union, Switzerland and the United States.