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Comment Richard Portes

Having read Alberto Giovannini's chapter, I feel I have crossed a barrier: I finally understand clearing and settlement (C&S), if not the complicated plumbing, at least the underlying issues. Europe has "Polish plumbers"

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(just not enough of them), in the American election campaign we saw "Joe the plumber," and securities markets everywhere have plumbing. It is very important.

But it is difficult. Even "Joe the plumber" did not have a proper license, and I certainly do not. Alberto acknowledges the "technical nature of the subject"—he even calls it "arcane"—but he then proceeds to inflict it on us, just because it is so important. The chapter gives a great description and analysis of C&S processes, of industry structure and its evolution.

The main message is that the key to reform is the political economy of obstacles to reform—identifying the rents and who earns them, and trying to counteract the resulting lobbies. The chapter argues that we cannot rely on the market participants to generate reform unaided. We need a top-down solution: for example, Big Bangs (major securities market liberalizations) have always been imposed against the wishes of market participants, most of whom then benefited, however, from consequent huge increases in turnover.

Reforming C&S is a major step in achieving financial integration. But how should we *define and measure* financial integration? My preferred perspective relies on the *law of one price (LOP):* assets generating identical cash flows should command the same return regardless of the domiciles of issuer and asset holder. Thus, cross-border flows of assets are neither necessary nor sufficient for integration. The LOP may hold without any flows at all; and cross-border flows may not equalize returns if there are cross-country differences in institutions' monopoly power. Nevertheless, we do look at quantities as well as prices: levels of *cross-border financial market activity.*

Another definition of financial market integration comes from the European Central Bank (ECB). Not surprisingly, it takes a more institutional perspective, saying that the market for a given set of financial instruments and/or services can be regarded as fully integrated if all potential market participants with the same relevant characteristics have the following:

1. Face a single set of rules when they decide to deal with those financial instruments and/or services.
2. Have equal access to the aforementioned set of financial instruments and/or services.
3. Are treated equally when they are active in the market.

Alberto's definition is very different from either. He defines a "market" by "the arrangements put in place to assure delivery of goods and of payments to the counterparties in each trade." This sees the market as posttrading, not trading itself, and this is his criterion for financial integration in a region—seamless, competitive posttrading. I find this rather idiosyncratic and surely *too narrow*—even Alberto slips into talking about exchanges, about "national financial markets" in the conventional sense. And sometimes he distinguishes between a market and its "infrastructure" ("plumbing"). Moreover, the definition is not quantitative. This is a problem when making intertemporal comparisons or trying to assess the effect of monetary union.

Taking a broader perspective, we can see that in addition to problems of C&S, many other obstacles can hinder financial integration: capital controls; different tax codes; accounting and auditing differences; different bankruptcy laws; different requirements of different regulatory authorities (e.g., consumer protection rules) that entail that financial institutions have to market different products across countries; weaknesses in judicial enforcement of contracts; the market structure of exchanges; and restrictive practices. The single market programme (SMP) and Financial Services Action Plan (FSAP) have attacked many of these barriers, however, and technological advances and market forces have mitigated their effects.

Thus, home bias in equity markets is falling, especially in the European Monetary Union (EMU). Cross-border equity holdings have risen even more than the global expansion of cross-border activity. Returning to the LOP, we find significant euro area convergence in equity returns and a declining relative influence of U.S. markets on euro area equity markets. Other evidence of equity market integration includes the often-remarked switch from country to sectoral portfolio strategies and the development of pan-euro area index benchmarks (Dow Jones Stoxx, etc.).

We also see falling home bias in the bond markets and considerable integration of the euro area bond markets. Euro area corporate bond market integration is clear from the minimal role of country effects in determining yield spreads. Moreover, effective bid-ask spreads in the euro area corporate bond markets are now actually lower than in the United States (Biais et al. 2006).

Government bond market integration has been driven by competition (governments can no longer rely on a captive domestic investor base, so they must eliminate causes of market segmentation). But Treasuries and Debt Management Offices try to maintain liquidity in their own securities through various restrictive practices, often aided by primary dealers (Dunne et al. 2006). *Perfect* substitutability probably requires "joint and several liability", and that will not come for many years. Common issuance, however, is not infeasible, and the primary dealers have worked out detailed proposals. But there is strong resistance to common issuance, coming in part from the European Central Bank, for reasons that are not entirely clear. Still, *there is a lot of substitutability arising from having only a single futures contract at each maturity*—that is, a single benchmark (the Bund contract is used for hedging at the ten-year horizon).

Regression results from gravity models, in the spirit of Portes and Rey (2005), find that cross-border bond investment is 197 percent larger among euro area member countries than between other country pairs. Cross-border bond holdings increased 90 percent among euro countries from 1997 to

2004, over and above what a range of other variables can explain (Lane 2005). Common membership of the euro area raises bilateral portfolio equity holdings by 45 percent according to Coeurdacier and Martin (2007), and by 62 percent according to Lane and Milesi-Ferretti (2005). And as further evidence of financial market integration, the Feldstein-Horioka effect has vanished within the European Union (Jappelli and Pagano 2008).

The conclusion I draw from this is that although reform of C&S is slow, the obstacles to efficient C&S have not impeded significant progress in cross-border financial integration in the European Union. Much as I sympathise with Alberto Giovannini's frustration, much as I would like to see the vested interests overcome and the rents disappear, I am pleased to see that markets and regulators are having considerable effects nevertheless.

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