Executive Summary

In our previous report, *Rethinking Central Banking,* we made the case for a broader mandate for central banks and for monetary policy coordination. In this report, we lay out a complementary framework for cross-border banking flows and for improved regulatory coordination.

The traditional policy prescription for capital account opening is that the benefits of capital flows can be reaped by removing the impediments to unfettered capital movements one by one. Some allowance is made for emerging and developing economies to liberalize more slowly, given their weak institutions. However recent experience, such as the capital flow reversals in Europe, has shown that even advanced economies may be vulnerable to the unintended consequences of capital account liberalization when the procyclicality inherent in capital flows is not adequately addressed.

The procyclicality of capital flows can in principle be addressed through coordinated global regulation and globally coordinated monetary policy. However, in practice such coordination is not straightforward to design or implement, even when the interests of countries overlap or are congruent. And even when coordination is globally optimal, it may generate tensions with the valued prerogative of national governance.

Given the obstacles to global coordination, countries may have little choice but to design frameworks that mitigate the risks of cross-border flows at the national level. We provide a number of recommendations from the perspective of national policy makers.

Our main conclusions and recommendations are as follows:

- The policy maker's goal is to reap the benefits from cross-border capital flows while guarding against potential financial stability costs. Reaping the benefits requires, first and foremost, resisting vested interests that push for barriers to capital flows as a way of avoiding necessary structural reforms and fiscal adjustments. Good macroeconomic and structural policies form the bedrock of financial stability.
- Guarding against financial instability starts with keeping track of the complete matrix of gross cross-border capital flows and gross external asset and liability positions. Focusing on net flows is not enough. The detailed features of national balance sheets, at the level of gross flows, determine whether financial integration promotes risk sharing across countries or increases financial contagion.
- Persistent current account imbalances pose financial stability risks and have implications for the sustainability of net external asset positions. Discussions of global rebalancing should be linked to the broader debate on capital flows, including specifically the connections between capital flows and financial stability, the procyclical nature of such flows, and the role of monetary policy spillovers in magnifying that procyclicality.
- Foreign direct investment and equity portfolio investment are conducive to