increased international risk sharing and tend to be stabilizing. In contrast, credit flows, which are not always conducive to efficient risk sharing, have a greater potential to be destabilizing. Therefore, current biases in favor of debt financing over equity financing should be reduced.

- Most cross-border capital flows are channeled through global banks and are heavily procyclical. The procyclical nature of cross-border bank-intermediated credit flows has given rise to serious economic and financial instabilities. Effective regulation of cross-border banking is essential for domestic and global financial stability in a highly financially integrated world economy.

- The organizational and financial structure of global banks is important for the transmission of imbalances and therefore requires careful regulatory attention. Banks that are funded by stable deposits or long-term funding pose the least risk. In contrast, banks that rely on short-term wholesale funding represent a greater risk, irrespective of whether they are domestically-owned or branches/subsidiaries of foreign banks.

- Globally-enforced financial regulation together with global monetary policy coordination can reduce distortions sufficiently to allow countries to reap the benefits of capital flows while limiting risks to stability. In practice, though, political realities are likely to complicate multilateral discussions of banking regulation, while monetary policy tends to be conducted with domestic rather than global imperatives in mind.

- The incremental liberalization of capital flows in the pursuit of the ideal of the frictionless First Best outcome has not worked as advertised. The crisis in the euro area shows that the flaws with the incremental First Best approach are not simply a result of underdeveloped or inadequate domestic institutions, as traditionally argued in the emerging market and developing country context.

- Given the difficulties of attaining a unified global regulatory framework and efficiently coordinating monetary policies across countries, governments may need to resort to a Second Best approach in which they seek actively to manage capital flows. Macro-prudential policies can play a key role in this process by imposing targeted regulations on banks engaged in cross-border activities.

- Macro-prudential policies should operate on the asset side of a bank's balance sheet, as do loan-to-value and debt-to-income caps, and the liability side, through devices such as levies on the non-core liabilities. These policies should attempt to influence balance sheet management by banks through instruments like countercyclical capital requirements.

- For the euro area, the First Best outcome may still be attainable through sufficiently robust financial regulation together with banking integration. A full banking union with a single regulator, as has been proposed recently by the European Commission, would be an effective means to this end. Alternatively, national banking systems that are conservatively regulated at the national level—for instance, through macro-prudential measures that limit banks' reliance on short-term wholesale funding—would help moderate capital flows that could otherwise exacerbate procyclical behavior and generate risks. But the middle ground of fragmented financial systems with unimpeded capital flows has been shown by recent events to be untenable.