slower pace of financial integration for developing or emerging economies, citing their weaker institutions and more limited capacity to absorb and benefit fully from the inflows of capital.[1] In their view, however, the ideal of full capital account convertibility should still serve as the North Star that emerging-economy to which policy makers should navigate, even if they must steer close to land initially so as to avoid the perils of the open ocean that only advanced economies can navigate safely.

At the same time, recent events, from the subprime crisis in the United States to capital flow reversals and the banking crisis in Europe, have shaken faith that even advanced economies can harness the benefits of greater financial flows and deepen financial integration without incurring costs. The advanced countries that have been swept up first by the subprime crisis and now by the eurozone crisis are not the stereotypical emerging economies with weak institutions. Spain, for example, ranks high on traditional yardsticks of financial development such as the ratio of commercial bank assets to GDP, or of markers of financial integration such as cross-border liabilities as a proportion of GDP. And yet, those same measures of financial integration and development that were held up as yardsticks of progress have turned out instead to be the engines of financial distress as capital flow reversals have gathered pace in Europe. In contrast, it has been the emerging economies with what were presumed to be "weak" institutions and underdeveloped financial markets that have best weathered the storm.

These topsy-turvy outcomes have been disorienting for those who believed in the desirability of moving toward the ideal of liberalized, open financial markets in incremental steps. In this report, we will take stock of the traditional case for financial liberalization and offer our perspective on which principles have withstood the test of recent events and which ones now need rethinking.

What's So Special about Cross-Border Flows?

In practice, a sizeable portion of cross-border flows is intermediated by the banking sector. These are of the wholesale funding variety, much of it short term, that is liable to reverse quickly when financial conditions deteriorate. Why cross-border flows tend to be wholesale funding flows is an interesting research question in and of itself. For the policy maker, the intellectual quest to understand the reasons may be of less relevance than the fact that the underlying causes of the observed pattern may be difficult to dislodge, at least in the short term.

The border is also relevant as it is associated with the boundaries in policy making. When policy produces spillovers but coordination is less than perfect, the border becomes relevant in assessing policy alternatives. Whereas monetary, regulatory, and fiscal policies tend to be coordinated within a jurisdiction, coordination is more difficult across borders. These problems are particularly acute with regard to bank flows, which not only account for a large proportion of total cross-border flows but are also more volatile.[2]

Consider bank regulation. Without a global rulebook, there is the danger that policy measures that are in a nation's interest take priority over the globally optimal policy measure. For example, national

[1] Clear-cut evidence on the positive effects of financial integration on growth has been elusive, however. Some studies show capital flows are beneficial in developing countries provided they have strong institutions and that there are thresholds effects (Prasad et al., 2003, Arteta et al, 2001). But the survey by Kose et al. (2009) concludes that the cross-country evidence lacks robustness. Prasad et al (2007) and Gourinchas and Jeanne (2007) note that emerging market and developing countries that have grown most rapidly did so without much foreign capital. The meta-analysis of Jeanne et al (2012) points to a threshold effect in which rich country growth rates are positively associated with financial integration but notes the lack of clear-cut general evidence.

[2] Subsidiarization does not resolve this problem, as the examples of Hungary and other emerging East European countries that are subsidiaries of Western European banks show. We return to this issue later in our report.