regulators in Europe did not force their banks to recapitalize but instead allowed them to shed foreign assets and withdraw from foreign markets. A second example is ring fencing. In this case each country attempts to grab the assets of a weak multinational bank before the other countries and thereby endangers a possibly viable bank. Common ground rules for banking regulation should be established to prevent these costs being imposed by one county on another.

The multilateral process governing reform of banking regulation led by the G20, Financial Stability Board (FSB), and the Basel Committee on Banking Supervision (BCBS) has shown how difficult such discussions can be. The negotiations over the new Basel III rules on international banking started with great fanfare in the aftermath of the 2008 crisis but soon morphed into a long-running set of trade negotiations where delegates felt impelled to be patrons of domestic banking interests. In retrospect, some delegates (especially from Europe) may now feel that their resistance to tougher capital requirements in the early stages of the Basel III negotiations (when their banks still had access to equity markets) may even have been detrimental to their own domestic public interest, as well as holding back better global banking rules.

In addition, the fact that the appropriate pace and sequencing of regulation may differ across countries creates tensions around the negotiating table. The different timing in implementation of the Basel guidelines across main financial centers (the U.S., for example, implemented Basel II more slowly than the Europeans) similarly creates distortions and opportunities for regulatory arbitrage.

Analogous distortions are also present in the conduct of monetary policy. Here, the monetary policy of the Federal Reserve takes on particular importance given the role of the U.S. dollar as the currency that underpins the global banking system. Given the political realities that make domestic economic policy paramount in determining a country's monetary strategy, global coordination of monetary policy is even further removed from the realms of realistic procedural goals than is global financial regulation [see our earlier report *Rethinking Central Banking*].

First Best vs Second Best

In light of the above discussion, we take a step back to consider how we may progress from a set of far-from-ideal circumstances to a better outcome.

The First Best approach takes as its ideal the frictionless model of the economy and regards the deviations from the frictionless model as sufficiently small that policies that eliminate those deviations one by one are presumed to take the economy closer to the frictionless outcome.

The First Best approach rests on the premise that markets are self-correcting through the virtuous circle generated by the stabilizing interactions of market signals and the decisions guided by those signals. Unwise and misguided policies can be removed and other market imperfections can be eliminated one by one, after which the market mechanism will push the economy to a better outcome. The views associated with the Washington Consensus, or more generally any listing of independent guiding principles, would be an example of the First Best perspective.

The Second Best approach, in contrast, rests on a more cautious view of the durability, stability, and desirability of unfettered capital markets. Because it takes distortions as more permanent, it does not presume that markets are self-correcting. As a result of such distortions, the Second Best approach allows the possibility that the interaction between market signals and decisions guided by those signals may not generate a stabilizing virtuous circle.

Thus the Second Best approach rests on a more pessimistic view of whether distortions in global capital markets and the incentives governing its key participants as well as its regulators can be