removed or altered materially. As long as these distortions are present in global capital markets, policy makers might be prudent to take those distortions as givens and adapt policy accordingly.[3]

Crucially, the Second Best approach has less faith that a piecemeal method of removing one distortion at a time will improve economic outcomes. Although regulatory interventions distort the working of the market mechanism, they may end up neutralizing other deep-seated distortions, so that the outcome with two distortions (e.g., procyclicality and interventions) may be better than the outcome with just one (e.g., procyclicality alone).

Even if one acknowledges the validity of the Second Best approach as an abstract proposition, extracting specific policy prescriptions is more difficult. This entails identifying not just impediments to frictionless markets (the task of the First Best approach) but also establishing how they interact and figuring out what combination of interventions will help enhance the net benefits of capital flows. This is a harder task, and clearly one subject to potential error. But it is the one we must attempt insofar as we believe that the frictionless ideal is impossible to achieve in short order.

Our report can be seen as an attempt to shed light on the considerations that could be invoked in formulating policy prescriptions by operationalizing the Second Best approach. The Second Best approach will suggest policies that attempt to manage capital movements rather than allowing them to flow freely. Of course, if the reason that the benefits of financial integration cannot be obtained is the lack of policy coordination, then a political framework that allows for a better coordination and integration of fiscal, prudential, and monetary policies should allow the benefits of free capital flows to outweigh the stability costs.

For the euro area, which could be seen as having the most favorable conditions for achieving close policy coordination, more thoroughgoing integration of financial systems may be superior to the direct control of flows. Observers may differ in their assessments of where the exact boundary beyond which full integration is the better route. However, the case for full integration as the solution to the eurozone crisis can be presented coherently and is consistent with arguing for greater fragmentation elsewhere.

Capital Flows in the Euro Area

The euro area already has institutions for conducting joint monetary policy within its borders. The euro area comes closest to replicating the features that are generally characteristic of a single sovereign jurisdiction. All is not well in Europe, to be sure, and the fact that it is experiencing severe disruption in cross-border financial flows should push us to think harder about how this has happened. It should also spur us to understand the limits of financial integration and what the corresponding policy remedies are.

The euro area is part of the wider EU where capital controls were made illegal with the introduction of the Single Market in 1992.[4] This provision applies to capital flows both within the EU and with the rest of the world, although some controls are still permitted under exceptional circumstances. Furthermore, the European single market prohibits giving preferential regulatory or tax treatment to domestic assets. While French legislation can treat euro-denominated assets and dollar-denominated assets differently, it cannot treat French and German stocks and bonds differently. Responsibility for bank supervision and resolution remains in national hands (at least so far; plans for a

[3] See Rodrik (2011) for further elaboration on the difference between the First Best and Second Best approaches to capital flows.
[4] There are some limited exceptions provided for in Article 65 of the EU Treaty.