banking union among euro area members are being discussed by heads of state and government) albeit on the basis of a common rulebook. Bank support is monitored by the European Commission, which can and has intervened to limit distortions to fair competition. In this sense, the euro area could be described as a pure monetary union (without a financial union) embedded in a single market for financial products.

Starting in 2009, the euro area has been subject to major disruptions of cross-border capital flows, amounting to a classic "sudden stop" well known in the context of emerging market economies.[5] It would be fair to say that this abrupt capital flow reversal surprised most European policy makers. Until it happened, conventional wisdom held that current account deficits within the monetary union would be financed in the same way they are financed within a single sovereign jurisdiction.

How can capital flow reversals take place within a monetary union when it does not take place in other single sovereign jurisdictions? One can put forward three reasons:

- Banks, though increasingly diversified, still exhibit home bias. National regulators are reluctant to push banks to engage in further cross-border diversification, perhaps because of turf issues or the desire to protect domestic economic interests. Declining real estate prices and doubts about the solvency of the sovereign and private agents then give rise to doubts about the solvency of the national banks.
- Responsibility for resolution of failed banks still resides at the national level. Consequently the creditworthiness of the sovereign is directly affected by concerns about the solvency of banks in its jurisdiction. Some bank balance-sheets are oversized relative to the fiscal capacity of the sovereign. Moreover, banks hold a substantial quantity of sovereign bonds issued by their governments. Through the interaction of these various factors, domestic bank solvency and sovereign solvency are linked.
- Since there is no credible fiscal oversight within the euro area, a country's government could overspend if its debt were commonly guaranteed by the entire euro area. This makes market discipline necessary—that is, fiscal spending has to be disciplined by the possibility of debt default. For this reason, the European Central Bank's mandate precludes purchasing sovereign debt in the primary market and the ECB has (until very recently) been reluctant to purchase large amounts of sovereign debt in the secondary market.

Despite the consequent scope for sudden stops within the euro area, Europe's monetary union can nonetheless be seen as the ideal case study for full integration as the optimal treatment of international capital flows. It represents perhaps the most favorable environment in which the First Best perspective of a fully integrated financial system may be a guide for policy. An analogy would be the financial development of the United States and how it overcame the borders between individual states. Much therefore hangs on the success or failure of the European policy response. If the First Best approach fails in the euro area, it is likely to be inappropriate in other settings where the preconditions are less favorable.

With this as preamble, let us turn now to examining key aspects of capital flows.

[5] See Merler and Pisani-Ferry (2012) for the parallels between the capital flow reversals in the Euro area and emerging economy "sudden stops".