is the one institution with the balance sheet capacity to act as lender of last resort.

There are also compelling arguments against a unified model. One disadvantage is that it makes the central bank more susceptible to political interference. The central bank will have to work hard to establish the legitimacy of its actions in circumstances where the nature of threats to financial stability may be poorly understood and its actions are unpopular. The public and its elected representatives may not be happy, for example, if the central bank curbs credit growth and causes asset prices to fall, and they will pressure the authorities to reverse course.

The unified model may also pose a conflict of interest for the central bank, which may, for example, be tempted to keep interest rates aritificially low in an effort to aid distressed financial institutions, or to treat a bank facing a solvency problem (a matter properly addressed by the fiscal authority or its agents) as if it were facing a liquidity problem.

If, on balance, the decision is to make the central bank the macroprudential supervisor, this approach should go hand in hand with measures to strengthen its independence from political pressure. To this end, it is important for the central bank to participate in the public discussion of how its performance will be evaluated. More regular communication of the rationale for its policies will also become increasingly important.

In sum, there are advantages to both models, and individual countries' institutional characteristics and political settings will determine what works best. Whatever the mechanism, it is clear that effective coordination between monetary and financial regulatory policies will be the lynchpin of financial stability.

Exchange Rates and Monetary Policy

The external dimension of monetary policy is critically important for small open economies with open capital accounts. Capital flows and exchange rate movements are important for price-level developments. They are important for financial stability as well: in open economies, monetary policy may have limited effectiveness in influencing credit developments because, inter alia, financial intermediaries can substitute external funding for domestic funding.

Macroprudential tools that lean against credit developments can give the central bank some measure of monetary policy autonomy, weakening the link between domestic monetary policy and capital inflows. For instance, by leaning against credit expansion, the central bank may be able to reduce the incentive for banks to borrow externally when domestic interest rates are increased.

The tensions between these different facets of economic stabilization become more acute when the currency is strong relative to fundamentals and the government wants to prevent excessive appreciation. This puts the central bank in a corner when domestic demand is also too strong. There is then the need to cool an overheating economy by allowing the appreciation of the currency, on the one hand, but pressure to guard against the erosion of competitiveness from what might prove to be only a temporary appreciation, on the other. Capital controls that moderate financial inflows, especially short-term inflows that are channeled through the domestic banking sector, may alleviate the policy dilemma but their role as a legitimate part of the policy maker's toolbox remains controversial.

Much commentary takes for granted that "capital controls don't work."[10] Commentators making

[10] See, for instance, the following editorial in the Wall Street Journal: Capital-Control Comeback: As Money Flows to Asia, Politicians Play King Canute, 2010, June 17. http://online.wsj.com/article/SB10001424052748704289504575312080651478488.html