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Free Enterprise: Financial crisis pits world against U.S.

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It's Europe against the United States - again. But this time, the Europeans as well as some Asian countries appear to have the better arguments. The dispute is about what lessons we may have learnt from the (still ongoing) financial crisis and how best to prevent something of this magnitude from ever happening again.

The battle over who will direct a restructuring of the international financial system is currently fought out at a G-20 (www.g20.org [1]) conference in the U.K.

Perhaps ominously, the Finance Ministers and Central Bank Governors of the 19 member countries plus the European Union (accounting for approximately 85 percent of world output) started their two-day meeting on Friday. On the agenda are questions regarding the short-term and long-term macro-financial response, the reshaping of the global financial system and the appropriate role of international financial institutions.

The main disagreement appears to be that the U.S. would like to first and foremost focus on how to alleviate the crisis, specifically by urging other industrialized countries to increase their stimulus efforts, and to leave the new laws and policies alone until careful studies are concluded.

Conversely, many major European trading partners of the U.S. would prefer to immediately discuss a wholesale reshaping and harmonization of how international capital flows are regulated. Fundamentally, what those other countries are saying is that they require additional assurances regarding how their taxpayer money is going to be used in the global financial system before putting up more money to stabilize, if not rescue, it.

This situation of governments not wanting to put up money is eerily analogous to what transpired in private financial markets when participants suddenly stopped extending credit.

In a just-published analysis (available at http://tinyurl.com/c4yz3s [2]), Princeton economics professor Markus K. Brunnermeier brilliantly describes how individuals behaving rationally led to socially suboptimal outcomes and, eventually, to the current deep recession. His attempt at "Deciphering the Liquidity and Credit Crunch 2007-2008" is also one of the best early insights into what went wrong, which is a first necessary step in determining how to prevent risks to the whole system in the future.

Although there is plenty of blame to go around, most fingers are pointing at the U.S. As has been

acknowledged, the precipitous increase in mortgage delinquencies starting in 2007 led to a "full-blown liquidity crisis" during which financial institutions were realizing enormous losses and banks started to hoard money because they did not trust their counterparts.

Such finger-pointing is potentially worrying, especially given that the United States has traditionally been able to keep in check those countries that would want to regulate all global money flows with abandon.

In essence, what is needed is both - less opaqueness through new regulations and additional efforts by all countries to weather the crisis - but in moderation. As economists like Brunnermeier have pointed out, "credit risk problems are more easily overcome if a clearinghouse or another central authority or regulator knows who owes what to whom" (p. 97).

That is the very idea of increased transparency. However, this need not require a whole new regulatory system, which might pose the danger of permanently inhibiting vital capital flows across the world.

As it turns out, the Europeans may very well have the better arguments, but the U.S. side seems to still have the better (less intrusive) solutions.

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