

By George Friedman

A complex sequence of meetings addressing the international financial crisis took place this weekend. The weekend began with meetings among the finance ministers of the G-7 leading industrialized nations. It was followed by a meeting of finance ministers from the G-20, the group of industrial and emerging powers that together constitute 90 percent of the world's economy. There were also meetings with the International Monetary Fund (IMF) and World Bank. The meetings concluded on Sunday with a summit of the eurozone, those European Union countries that use the euro as their currency. Along with these meetings, there were endless bilateral meetings far too numerous to catalog.

The weekend was essentially about this: the global political system is seeking to utilize the assets of the global economy (by taxing or printing money) in order to take control of the global financial system. The premise is that the chaos in the financial system is such that the markets cannot correct the situation themselves, and certainly not in an acceptable period of time; and that if the situation were to go on, the net result would be not just financial chaos but potentially economic disaster. Therefore, governments decided to use the resources of the economy to solve the problem. Put somewhat more simply, the various governments of the world were going to nationalize portions of the global financial system in order to stave off disaster. The assumption was that the resources of the economy, mobilized by the state, could manage - and ultimately repair - the imbalances of the financial system.

That is the simple version of what is going on in the United States and Europe - and it is only the United States and Europe that really matter right now. Japan and China - while involved in the talks - are really in different places structurally. The United States and Europe face liquidity issues, but the Asian economies are a different beast, predicated upon the concept of a flood of liquidity at all times. Damage to them will be from reduced export demand, and that will take a few weeks or months to manifest in a damning way. It will happen, but for now the crisis is a Euro-American issue.

The actual version of what happened this weekend in the financial talks is, of course, somewhat more complex. The United States and the Europeans agreed that something dramatic had to be done, but could not agree on precisely what they were going to do. The problem both are trying to solve is not technically a liquidity problem, in the sense of a lack of money in the system - the U.S. Federal Reserve, the European Central Bank and their smaller cousins have been pumping money into the system for weeks. Rather, the problem has been the reluctance of financial institutions to lend, particularly to other financial institutions. The money is there, it is just not getting to borrowers. Until that situation is rectified, economic growth is pretty much impossible. Indeed, economic contraction is inevitable.

After the failures of so many financial institutions, many unexpected or seemingly so, financial institutions with cash were loath to lend money out of fear that invisible balance-sheet problems

would suddenly destroy their borrowers, leaving lenders with worthless paper. All lending is driven by some appetite for risk, but the level of distrust - certainly after many were trapped in the Lehman Brothers meltdown - has meant that there is no appetite for risk whatsoever.

There is an interesting subtext to this discussion. Accounting rules have required that assets be "marked to market," that is, evaluated according to their current market value - which in the current environment is not very generous, to say the least. Many want to abolish "mark to market" valuation and replace it with something based on the underlying value of the asset, which would be more generous. The problem with this theory is that, while it might create healthier balance sheets, financial institutions don't trust anyone's balance sheet at the moment. Revaluing assets on paper will not comfort anyone. Trust is in very short supply, and there are no bookkeeping tricks to get people to lend to borrowers they don't trust. No one is going to say once the balance sheet is revalued, "well, you sure are better off than yesterday, here is a hundred million dollars."

The question therefore is how to get financial institutions to trust each other again when they feel they have no reason to do so. The solution is to have someone trustworthy guarantee the loan. The eurozone solution announced Oct. 12 was straightforward. They intended to have governments directly guarantee loans between financial institutions. Given the sovereign power to tax and to print money, the assumption was - reasonable in our mind - that it would take risk out of lending, and motivate financial institutions to make loans.

The problem with this, of course, is that there are a lot of institutions who will want to borrow a lot of money. With the government guaranteeing the loans, financial institutions will be insensitive to the risk of the borrower. If there is no risk in the loan whatsoever, then banks will lend to anyone, knowing full well that they cannot lose a loan. Under these circumstances, the market would go completely haywire and the opportunities for corruption would be unprecedented.

Therefore, as part of the eurozone plan, there has to be a government process for the approval and disapproval of loans. Since the market is no longer functioning, the decision on who gets to borrow how much at what rate - with a government guarantee - becomes a government decision.

There are two problems with this. First, governments are terrible at allocating capital. Politics will rapidly intrude to shape decisions. Even if the government could be trusted to make every decision with maximum efficiency, no government has the administrative ability to manage the entire financial sector so directly. Second, having taken control of interbank finance, how do you maintain a free market in the rest of the financial system? Will the government jump into guaranteeing non-interbank loans to ensure that banks actually lend money to those who need it? Otherwise the banking system could be liquid, but the rest of the economy might remain in crisis. Once the foundation of the financial system is nationalized, the entire edifice rests on the nationalized system.

The prime virtue of this plan is that it ought to work, at least in the short run. Financial institutions should start lending to each other, at whatever rate and in whatever amounts the

government dictates and the gridlock should dissolve. The government will have to dive in to regulate the system for a while but hopefully - and this is the bet- in due course the government can unwind its involvement and ease the system back to some sort of market. The tentative date for that unwinding is the end of 2009. The risk is that the distortions of the system could become so intense after a few months that unwinding would become impossible. But that is a problem for later; the crisis needs to be addressed now.

The United States seems to dislike the eurozone approach, at least for the moment. It will be interesting to see if Washington stays with this position. U.S. Treasury Secretary Henry Paulson, who appears to be making the decisions for the United States, did not want to obliterate the market completely, preferring a more indirect approach that would leave the essence of the financial markets intact.

Paulson's approach was threefold. First, Washington would provide indirect aid to the interbank market by buying distressed mortgage-related assets from financial institutions; this would free up the lenders' assets in a way that also provided cash, and would reduce their fears of hidden nightmares in each others' balance sheets. Second, it would allow the Treasury to buy a limited stake in financial institutions that would be healthy if not for the fact that their assets are currently undervalued by the market; the idea being that the government takes a temporary share, in exchange for cash that will recapitalize the bank and reduce its need for access to the interbank market. Finally - and this emerged at 2 a.m. on Monday - the government would jump into the interbank market directly. The Federal Reserve promised to lend any amount of dollars to any bank so long as the borrower has some collateral that the Fed will accept (and these days the Fed accepts just about anything). The major central banks of Europe have already agreed to act as the Fed's proxies in this regard.

The United States did not want to wind up in the position of micromanaging transactions between financial institutions. Washington felt that an intrusive but still indirect approach would keep the market functioning even as the government intervened. The Europeans feared that the indirect approach wouldn't work fast enough and had too much risk attached to it (although the Fed's 2 a.m. decision may take the air out of that belief). They also believed Washington's attempt to preserve the market was an illusion. With the government buying distressed paper and investing in banks, they felt, what was left of the market wasn't worth the risk or the time.

There is also an ideological dimension. The United States is committed to free-market economics as a cultural matter. Recent events have shown, if a demonstration was needed, that reality trumps ideology, but Paulson still retains a visceral commitment to the market for its own sake. The Europeans don't. For them, the state is the center of society, not the market. Thus, the Europeans were ready to abandon the market much faster than the Americans.

Yet the Europeans and the Americans both had to intervene in some way, and now they face exactly the same problem: having decided to make the pig fly, there remains the small matter of how to build a flying pig. The problem is administrative. It is all very well to say that the government will buy paper or stock in companies, or that it will guarantee loans between banks. The problem is that no institutions exist to do this. There are no offices filled with officials empowered to do any of these things, no rules on how these things are to be done, no bank

accounts on which to draw - not even a decision on who has to sign the checks. The faster they try to set up these institutions, the more inefficient, error-prone and even corrupt they will turn out to be. We can assure you that some bright lads are already thinking dreamily of ways to scam the system, and the faster it is set up, the fewer controls there will be.

But even if all of that is thrown aside, and it is determined that failure, error and corruption are an acceptable price to pay to avoid economic crisis, it will still take weeks to set up either plan (with the possible exception of the Fed's announcement to jump into the interbank market directly). Some symbolic transactions can take place within days - and they will undoubtedly be important. But the infrastructure for processing tens of thousands of transactions simply takes time to build.

This, of course, is known to the eurozone finance ministers. Indeed, the Europeans will hold an EU-wide summit on the topic this week, while the Americans are going to be working very hard to clarify their own processes in the next few days. The financial institutions will need to have guarantees to start lending - or some sort of retroactive guarantee - but the bet is that the stock markets will stop falling long enough to give the finance ministries time to get organized. It might work.

We need to add to this another dimension we find very interesting. We have discussed elsewhere the axes on which this decision will be made: one is the degree of government intervention, the other is the degree of international collaboration. Clearly, governments are going to play the pivotal role. What is interesting is the degree to which genuine international collaboration is missing. Certainly there is voluntary collaboration - but there is not an integrated global strategy, there is not an integrated global institution administering the strategy, nor is there an irrevocable commitment on the part of governments to subordinate their sovereignty to relevant global institutions.

The Americans and Europeans seem to be diverging in their approaches, with Paulson delivering a warning about the consequences of protectionism. But the European Union is also now being split between members of the eurozone and EU members who have their own currencies (primarily the United Kingdom). Indeed, even within the eurozone, the solutions will be national. Germany, France, Italy and the rest are all pursuing their own bailouts of their own institutions. They have pledged to operate on certain principles and to coordinate - as have the United States and Europe - but the fact is that each state is going to execute a national policy through national institutions with its own money and bureaucracies.

What is most interesting in the long run is the fact the Europeans, even in the eurozone, have not attempted a European solution. Nationalism is very much alive in Europe and has emerged, as one would expect, in a time of crisis. And this raises a crucial question. Some countries have greater exposure and fewer resources than others. Will the stronger members of the eurozone help the weaker? At present it seems any such help would be simply coincidental. This is a global question as well. The Europeans have pointed out that the contagion started in the United States. It is true that the Americans sold the paper. But it is also true that the Europeans bought it readily. If ever there was a systemic failure it was this one.

However, it has always been our view that the state ultimately trumps the economy and the nation trumps multinational institutions. We are strong believers in the durability of the nation-state. It seems to us that we are seeing here the failure of multinational institutions and the re-emergence of national power. The IMF, the World Bank, the Bank for International Settlements, the European Union and the rest have all failed to function either to prevent the crisis or to contain it. The reason is not their inadequacy. Rather it is that, when push comes to shove, nation-states are not prepared to surrender their sovereignty to multinational entities or to other countries if they don't have to. What we saw this weekend was the devolution of power to the state. All the summits notwithstanding, Berlin, Rome, Paris and London are looking out for the Germans, Italians, French and British. Globalism and the idea of "Europe" became a lot less applicable to the real world this weekend

It is difficult to say that this weekend became a defining moment, simply because there is so much left unknown and undone. Above all it is unclear whether the equity markets will give governments the time they need to organize the nationalization (temporary we assume) of the financial system. No matter what happens this week, we simply don't yet know the answer. The markets have not fallen enough yet to pose an overwhelming danger to the system, but at the moment, that is the biggest threat. If the governments do not have enough credibility to cause the market to believe that a solution is at hand, the government will either have to throw in the towel or begin thinking even more radically. And things have already gotten pretty radical.

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