EMOTIONS RAN HIGH AT LAST WEEK'S MEETING of G-7 finance ministers in Essen, Germany. Euro-zone officials were annoyed with their Japanese counterparts because the yen had sunk to all-time lows against the euro, signaling trouble for the Continent's exporters. Tokyo sniped that the euro was buoyed mainly by European Central Bank interest rate rises. U.S. Treasury Secretary Hank Paulson pooh-poohed Europe's charges against Japan, attributing the weak yen to market forces. But Paulson then pointed a finger at Beijing for not revaluing fast enough. In other words, everyone was mad at everyone else.

You would have thought that Wall Street, the City of London, and other financial centers would have paid more attention to the fireworks. After all, currency tensions can be an early warning of broader troubles. In the late 1980s, for example, squabbling among the United States, Japan and Germany over the relative values of the dollar, yen and D-mark was a precursor to the 1987 global stockmarket crash. Could it be that today's financiers and traders, enjoying several uninterrupted years without a crisis, have grown complacent?

I think it's something else—namely the fact that markets have become so much bigger and more powerful than governments. According to a recent McKinsey study, in 1986 the size of the global capital market was about equal to global GDP. By 2005, the market had grown to roughly three times world GDP, or $140 trillion, and within three years from now it is expected to grow to $228 trillion. Looked at another way, the size of the global capital market is about 70 times the combined foreign exchange reserves of China and Japan, by far the world's two largest holders. Moreover, there has been a dramatic increase these past few years in virtually every asset class including stocks and bonds, foreign exchange, foreign investment, derivatives, private equity and hedge funds.

There's another reason that Wall Street doesn't take government pronouncements seriously: the disconnect between words and actions. The markets know that when public officials bicker over exchange rates, it's just hot air unless treasuries and central banks intervene to prop up or push down currencies. Likewise, when the politicians bang on about the dangers of long-term financial imbalances, it means nothing to traders unless it's followed by legislation to change taxes. Right now, such policy measures aren't being taken, either because of lack of political will, or because ministers are quietly satisfied with the status quo.

It's hard to blame bankers, traders, and institutional investors for discounting what governments say. After all, while politicians have been wringing their hands over trade imbalances, the financial regulatory system has smoothly recycled hoards of savings from Asia to plug America's deficits. As officials scream about protectionism, the markets are integrating China, India and other emerging markets into the global economy quicker than anyone would have imagined.

The problem here is that private and public power are completely out of synch—and getting more so every day. No one really knows what kinds of dangerous liabilities are mounting in the capital markets, in which institutions they reside, or how big the risks are. Complex hedging instruments like default swaps and collateralized debt obligations are multiplying faster than anyone's ability to track them. There is a high probability that in today's desperate search for yield, capital markets are underpricing all manner of new lending, while moving into many areas that are beyond the purview of the effective regulation. Unless the lessons of history are irrelevant, it is a fantasy to think that markets can police themselves.

It doesn't help that national governments have differing views on key questions like accounting standards, securities laws or how to monitor hedge funds. This lack of consensus is a serious deficiency, because it will take more than sound national regulation to oversee the integrated global financial system; in fact, it will require a degree of international collaboration and financial leadership that is nowhere in sight.

If the G-7 meetings are a side show today, they are likely to become even more so in the years ahead. The past implies that only a major economic debacle can motivate governments to reassert their legitimate and necessary regulatory authority. That's what happened after the Great Depression, after World War II, and after the U.S. delinked the dollar from gold in 1971, ushering in an era of floating exchange rates and new monetary arrangements. Sadly, it seems we will have to wait for another calamity to bring public and private power back into balance.

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