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**Financial storm ahead**
As inflation and interest rates creep up and central banks lose control, it is imperative that Asia work toward stronger regional currency cooperation. The first steps have been taken, but a storm is brewing and Asia must get its act together. - **Joergen Oerstroem Moeller**

## Warning: Financial chaos ahead

By Joergen Oerstroem Moeller

SINGAPORE - After relative calm on the currency markets over the past 15 years - albeit interrupted by a couple hiccups - sustained financial turmoil may be lurking.

An international monetary crisis is not a new phenomenon, but this time the extent, depth, violence and speed of capital movements chasing short-term profits may surpass anything the world has yet seen.

The central banks will step in to exercise damage control but, as in earlier crises, they may be caught on the wrong foot defending a system the market no longer believes in.

The post-1945 international monetary system falls in three stages. The first one lasted from the end of World War II to the early 1970s based upon fixed currency rates.

The second one ran from the early 1970s to the early 1990s with fluctuating rates in various editions, of which "managed floating" was the best known.

We are currently in the third stage, wherein central banks pursue inflation targeting, leaving the currency rates to the market and depriving them of their traditional role as economic-policy instruments.

The 1945-to-early-1970s model served the world very well. The markets took it for granted that rates reflected comparative and competitive positions. This cemented the assumption that they could be defended without much cost, which indeed proved to be the case until the system started to crack under the weight of large imbalances in the US economy in the late 1960s.

For a long time currency rates were not a topic for economic and monetary policy. They were where they were and few, if any, contested this state of affairs. Before the middle/late 1960s, when economic globalization emerged and made fixed rates obsolete, international trade and investment were not large enough to rattle the central banks.

From the early 1970s and for 20 years plus, currency upheavals became almost the order of the day. Global speculation unsettled the US dollar or the Japanese yen or the Deutschmark, as it was then. The major central banks had chosen to operate a system of managed currency rates vis-a-vis other currencies.

There were many reasons for adopting such a policy. The determining one was that fluctuating currency rates were thought to undermine trade and investment, thus jeopardizing economic growth. It didn't work out that way, though. The market did not believe in the currency rates pursued by the authorities and repeatedly pulled the carpet from beneath them, leaving the central banks hanging in the air.

Today the global economy is in the third stage. The world has lived happily for about 15 years under inflation targeting and without a major international currency crisis. But omens indicate that this may not last.

Since the early 1990s, almost all central banks have pursued inflation targeting with the goal of approximately 2% inflation. They have been successful. Global inflation has been kept at that level for nearly 15 years. Looking at the results, the market came to believe in the system. It is irrelevant whether this happy state of affairs was brought about by the central banks and their policies or by other factors. It happened, and that is what matters.

Now things are changing. A string of factors have entered the picture and pushed inflation above the targets. China may not be able to secure manufactured goods at the same low prices as it has over the past 15 years. Oil prices are hovering at a record high. Agriculture prices are beginning to rise, pushed by demand from the growing Asian middle class. This does not automatically mean higher inflation, as productivity gains in China and India are in the pipeline. What it does mean, however, is a rising belief that the era of automatic low inflation may be over.

As the central banks have nailed their flags to inflation targeting and unscrupulously claimed credit for its success, the market will - not surprisingly - expect them to prevent inflation from moving beyond the acceptable range. The central banks, however, had limited influence in trying to achieve low inflation rates and they will have similarly little effect in stemming the tide of higher prices.

The economy will suffer from higher interest rates. This will bring the era of excessive global liquidity to an end and stoke the market's skepticism of central-bank policies. This may shatter the market's confidence in central banks and the policies they have chosen and, ultimately, destroy confidence in the international monetary system.

It is the duty and prerogative of central banks and monetary authorities to give guidance to the market; to let it know what the currency-rate policy is. The market sizes these signals up and follows such guidance if, and only if, it believes in the policies. If that belief crumbles, market forces may become strongly destabilizing.

Slowly rising inflation, creeping interest rates and doubts about inflation targeting may produce exactly such a situation, one asking for strong global leadership, and it is highly doubtful whether the International Monetary Fund has the strength and reputation to step in and fulfill that role.

The outcome may be a global monetary system that is much less global but more regional, with large currency groups accumulating sufficient size to withstand international, disruptive capital movements. Very few if any currencies can - alone and isolated - withstand the onslaught of speculators.

For Asia and especially East Asia, having learned painful lessons in 1997-98, this signals a need for much stronger regional currency cooperation. The first steps have been taken with various schemes for currency credits, but as the potential storm gathers, it is high time that Asia gets its act together and moves beyond the embryonic stage.

The lesson from Europe's three decades of hard work toward an economic and monetary union, the secret of central banking and how to counteract speculative capital movements, is found in three key sentences easily forgotten, but nonetheless priceless, in a crisis or in preempting a crisis:

- The larger the currency area, the more resistance disruptive capital movements will meet (the larger the pond, the bigger a stone is needed to make ripples).
- The value of a currency depends on confidence, and confidence lasts only while it lasts.
- It is earned by actions and the implementation of policies, not by declarations of intent. What counts is what you do, not what you say.

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