

Viewpoints

July 2008

This article was originally published in the Financial Times on July 15, 2008

Crisis and Coherence: Finance Remains Vulnerable

By Mohamed El-Erian

July 15, 2008

In a few years, we shall look back at this time as one that redefined the landscape of the US financial system and, by association, the workings of global capital markets. The process is inevitably chaotic as it is driven by “crisis management” reactions rather than the calm implementation of well formulated medium-term measures. As such, the overall picture will become clear only over time. Yet it is possible to make specific predictions.

The financial system is at a crossroads. At current market prices, the system remains under-capitalized despite some \$350bn (€220bn, £176bn) of capital-raising over the past 12 months. More-over, given the collapse in their equity prices, a growing number of institutions, including such behemoths as Freddie Mac and Fannie Mae, the mortgage agencies, are essentially un-able to raise capital without government help. The longer this situation prevails, the higher the risk the financial system will face difficulties in raising other financing critical to day-to-day operations. This would accelerate forced sales of assets into illiquid markets, leading to another downward leg in an already vicious negative spiral.

This realization drove the recent emergency policy statements from Washington. It is the second time this year that such dramatic announcements were made on a Sunday – a phenomenon historically reserved for developing countries rather than industrial ones. It reflects the understandable eagerness to minimize forced and disorderly deleveraging in a part of the economy that is deeply interlinked with virtually everything else. The financial system is like the oil in your car. Without the oil, it no longer matters whether you have a solid engine, good brakes or fancy safety features. The car will not function.

There will be endless debate as to “who lost the financial system”. Some will blame defective lending practices; others will point to greedy borrowers or regulatory practices that failed to keep up with market developments. The time will come when this debate will shape the specific policy responses. For now, it can govern only the broad outlines; the details are inescapably driven by more immediate considerations, including the understandable desire in Washington to minimize the impact of the financial sector meltdown on the innocent (or, at least, less guilty) segments of society.

Accordingly, look for the official sector to encourage further capital-raising and work even harder to isolate the most vulnerable financial institutions and limit the negative spillover effects. For some institutions, especially the systemically important ones, this is likely to involve “facilitated marriages” similar to what occurred earlier this year in the cases of Bear Stearns and Countrywide. Others face the risk of explicit failure (as

Viewpoints

July 2008

occurred this weekend with IndyMac, the California-based bank). In all these cases, equity holders would experience additional pain while mechanisms would be triggered to protect certain deposits.

This is a practical approach aimed at striking that delicate balance between *laissez-faire* and government control. Yet it has important limitations. It does not work for large institutions such as Freddie and Fannie – thus the need for Sunday’s announcement of contingent equity and debt financing from the authorities. Also it cannot handle a large number of institutions facing difficulties. It is likely that additional steps will be needed, lest these limitations end up transforming the current economic and financial dislocations into something even more sinister.

Over the next few months, look for the Federal Reserve to face additional pressure to strengthen the emergency liquidity windows for systemically important institutions. Look for Congress to be asked to appropriate funds to support Freddie and Fannie more directly. Look for innovative mechanisms to raise additional capital for the financial sector through public-private partnerships. And look for other fiscal stimulus measures to counter the increasingly vicious spiral in housing and, soon, consumer demand.

Many of these steps involve distortions to the efficient functioning of markets over the longer term. Implementation is difficult and, in the absence of strong leadership, may not be timely enough. Yet the cost of doing nothing may be even higher. The key is whether all the ad hoc crisis management steps eventually evolve into a coherent and sustainable policy outcome. The jury is still out on this.

The writer, co-chief executive and co-chief investment officer of PIMCO, is author of When Markets Collide: Investment Strategies for the Age of Global Economic Change (McGraw Hill)

Past performance is not a guarantee or reliable indicator of future results. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material contains the current opinions of the author and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

This article was reprinted with the permission of The Financial Times Limited Copyright 2008