

Viewpoints

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Why this crisis is still far from finished

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During the past few weeks we have seen a growing number of market participants predict an end to the dislocations that erupted last summer and claimed victims throughout the financial system and beyond. While their predictions are understandable, they are premature. The dynamics driving the disruptions are morphing and may again move ahead of both the market and policy responses.

The optimistic view is based on two distinct elements. First, that the de-leveraging process is reaching its natural end as valuations stabilize and institutions come clean about their losses and raise capital; second, that a series of previously unthinkable policy responses have been effective in restoring liquidity to the financial system.

Both views have merit. Financial institutions, particularly in the U.S., have recognized the scale of the problem and are taking remedial steps. Just witness the recent round of capital raising by Citigroup, Merrill Lynch, JPMorgan and Wachovia. At the same time central banks in Europe and the U.S. have opened up their financing windows, expanding the size of the financing, the range of institutions that can access it and the list of eligible collateral.

Yet, consistent with what we have seen since last summer, the dislocations are entering a new phase. As such, bold reactions on the part of policymakers may, once again, prove to be too little and too late.

Persistent financial dislocations have now caused the real economy to become, in itself, a source of potential disruption. During the next few months there will be a reversal in the direction of causality: the unusual adverse contamination by the financial sector of the real economy is now morphing into the more common phenomenon of recessionary forces threatening to undermine the financial system.

Economic data in the U.S. have taken a notable turn for the worse. Most importantly, the already weakening employment outlook is being further undermined by a widely diffused build-up in inventory and falling profitability. History suggests that the latter two factors lead to significant employment losses.

Pity the U.S. consumers. Their ability to sustain spending is already challenged by the declining availability of credit, a negative wealth effect triggered by declining house values, and a lower standard of living as the result of higher energy and food prices and a depreciating dollar. Job losses will accentuate the pressures on consumers, leading to income declines and a further loss of confidence.

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While the financial system has taken steps to enhance balance sheets, they speak essentially to addressing the consequences of excessive leveraging and imprudent financial alchemy. As such, the nasty turn in the real economy may fuel another wave of disruptions that, this time around, would also have an impact on mid-size and smaller banks.

It is thus too early to declare the end of the turmoil that started last summer. Instead, during the next few months we may witness a new phase of dislocations, led this time by the real economy. The blame game will intensify; political pressure will continue to mount; momentum will build for greater and broader regulation of financial activities within the banking system and beyond.

The focus will also be on the reaction of policymakers. Here the outlook is mixed. The good news is that the crisis is now moving to an area where traditional policy tools are more effective. This is in sharp contrast to the situation of the past few months, where central banks were forced to use instruments that were too blunt for the purpose at hand.

But there is also bad news. The sharp slowdown in the U.S. real economy will occur in the context of continued global inflationary pressures. As such, the Federal Reserve's dual objectives - maintaining price stability and solid economic growth - will become increasingly inconsistent and difficult to reconcile. Indeed, if the Fed is again forced to carry the bulk of the burden of the U.S. policy response, it will find itself in the unpleasant and undesirable situation of potentially undermining its inflation-fighting credibility in order to prevent an already bad situation from becoming even worse.

It is still too early for investors and policymakers to unfasten their seatbelts. Instead, they should prepare for renewed volatility.

*The writer is co-chief executive and co-chief investment officer of PIMCO. His book, *When Markets Collide: Investment Strategies for the Age of Global Economic Change*, will be published by McGraw Hill in June.*

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