Viewpoints

April 2010

This article was originally published on [April 28, 2010 on the ft.com](#).

Greek Crisis Endangers Private Sector

By Mohamed El-Erian

I suggested last week, in what seemed like a counter-intuitive phenomenon to some, that sharply lower prices for Greek bonds would bring out sellers rather than buyers. Such sellers, and there are potentially too many of them, would be reacting late to the recognition that "safe" instruments that they bought for their "interest rate bucket" have turned out to be something else – namely, volatile credit exposure that is subjecting them to both financial loss and reputational damage.

No wonder late-moving sellers have been looking over the past few days to reduce their holdings of Greek bonds. This has accentuated market volatility and illiquidity. Combined with this week's downgrades in the credit ratings of peripheral European countries, the result has been a dramatic sell-off in European equities, a further disorderly widening in sovereign risk spreads and pressure on the euro.

The Greek debt crisis is now morphing into something much broader. No wonder the European Union and the International Monetary Fund are scrambling to regain control of the rapidly deteriorating situation. There is talk of a bigger bailout package for Greece. The heads of the European Central Bank and IMF have made the trip to Germany that is reminiscent of the Ben Bernanke–Hank Paulson trip to Congress in the midst of the U.S. financial crisis.

Markets are now catching up to the reality of over-burdened public finances in the aftermath of the global financial crisis. These developments are of particular concern to countries with elevated debt levels and challenging maturity profiles for this debt. Indeed, absent some dramatic change in sentiment, they will need to worry not only about their ability to mobilize new funding from the private sector at reasonable cost, but also about keeping their existing creditors on board. As a result, credit downgrades will multiply. And once a package is approved for Greece, there will be questions as to whether similar packages can be secured for other vulnerable countries in the European Union.

So, what else should the "official sector" be doing in its urgent quest to find a circuit breaker for the widening European crisis?

A number of things have to happen very fast over the next few days to have some chance of salvaging the situation. At the very minimum, the government in Greece must come up with a credible multi-year adjustment plan that, critically, has the support of Greek society; EU members must come up with sizeable funds that can be quickly released and which are underpinned by the relevant approval of national parliaments; and the IMF must secure sufficient assurances from Greece (in the form of clear policy actions) and the EU (in the form of unambiguous financing assurances) to lead and coordinate the process.

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This is a daunting challenge. The numbers involved are large and getting larger; the socio-political stakes are high and getting higher; and the official sector has yet to prove itself effective at crisis management.

Meanwhile, the disorderly market moves of recent days will place even greater pressure on the balance sheets of Greek banks and their counterparties in Europe and elsewhere. The already material risks of disorderly bank deposit outflows and capital flights are increasing. The bottom line is simple yet consequential: The Greek debt crisis has morphed into something that is potentially more sinister for Europe and the global economy. What started out as a public finance issue is quickly turning into a banking problem too; and what started out as a Greek issue has become a full-blown crisis for Europe.

Absent some remarkable change in the next few days, things will get even more complex for the official sector. It may have no choice but to combine its own exceptional financing efforts with talks on a controversial approach that will be familiar to veteran emerging market observers – PSI, or “private sector involvement.”

PSI is the polite way to talk about the restructuring of some of the sovereign debt held by the private sector. It is based on a concept of burden-sharing in a disorderly world. It can appeal to governments as a seemingly easy way to ensure that massive public sector support to crisis countries does not flow back out in the form of payments to private creditors. Yet PSI is also hard to design comprehensively, harder to implement well and involves collateral damage and unintended consequences.

About the author:
Dr. El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO at the end of 2007 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard’s endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, "When Markets Collide," was a New York Times and Wall Street Journal bestseller, won the Financial Times/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by The Economist. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.