

A Q&A with Nouriel Roubini: Roubini foresees troubled times ahead

Recently, the International Monetary Fund hosted a talk by Nouriel Roubini, Professor of Economics at NYU's Stern School of Business. The event was, to some extent, a follow up to Roubini's visit to the Fund one year ago. Last year, he predicted that the U.S. housing correction would not go away quietly and that the U.S. subprime market would cause broader problems for the financial system. At that time, he also attached a high probability on a U.S. recession occurring in 2007. With two of his three predictions coming to pass, many in the audience were wondering whether he still believed the third would soon materialize.

Roubini set out immediately to address questions that were on everyone's minds: Would the financial market turmoil persist, and would there be implications for the real economy? What is the likely course to be taken by the U.S. Federal Reserve? Would the U.S. economy suffer a hard landing, and would the rest of the world be able to de-couple from such a hard landing?

Is a U.S. recession looming?

In recent years, the U.S. economy has seen the build up of one of the biggest housing bubbles in its history. Many observers believe that a correction is in order. Roubini said he expects a decline in U.S. house prices of 15-20 percent but pointed out that experts like Yale's Robert Shiller have been warning of even larger declines. Roubini explained that as existing adjustable rate mortgages continue to come up for renewal at higher rates, many of these borrowers will be unable to meet the new higher payments, and defaults will rise—with some estimating that as many as 2.2 million people will lose their homes. As a result, the number of homes on the market will increase. This increase in the number of homes on the market will be exacerbated by house flippers, who have now begun unloading their properties, as well as by existing construction of new homes, because, although new construction has fallen, it has not fallen by enough to keep pace with the decreasing demand for new homes.

What does this mean for the broader economy in the U.S.? Roubini admits that since the housing sector accounts for only 5 percent of GDP, a slump in this sector by itself could not tip the economy into recession. However, the slowdown in the housing sector appears to be having spillover effects on other sectors that are important components of private consumption, which accounts for just over 70 percent of GDP. Auto sales have fallen sharply, as has consumption of consumer durables—things related to housing, like appliances, furniture, and so on. When house prices were on the rise, consumers found it easy to borrow against the rising value of their homes to finance their purchases. Now that the reverse is happening, there is already a meaningful slowdown in consumption growth to just 1.3 percent in the second quarter of 2007.

“You don't have just subprime mortgages in the U.S., you have thousands and millions of subprime auto loans or subprime credit cards and those are going to start going belly-up as well.”

What else is working against consumer spending? Consumers continue to face high and still rising oil prices, with the price of oil today at over \$80 per barrel. More importantly, however, U.S. consumers are also confronting uncertainty in terms of exactly how they will be affected by the credit crunch in the mortgage market as the subprime effects spill over not only to other parts of the mortgage market but also to the consumer credit market. If the effects are significant, the resulting increase in debt servicing costs for households will have a negative effect on consumption.

Do the employment numbers matter in all this? Roubini admits that until recently, even with all of these headwinds facing consumers, as long as job creation and income generation continued, U.S. consumer spending may have again proven remarkably resilient. However, given the recent disappointing data on employment, this may change. Roubini posits that if employment is viewed as a lagging indicator of the business cycle and there is a downturn, “that is a signal that probably the business cycle has already turned a few months ago. So if employment is already falling now, then we must be really in trouble.”

Will the corporate sector be the economy’s knight in shining armor? Roubini acknowledges that a corporate sector that is “lean and mean” with high profitability could provide a counter-weight to an otherwise bleak outlook. Roubini recalled that “for the last few years there has been this puzzle of this investment strike of the corporate sector and even the Fed recognized that, given profitability, spending has been weak” even before the credit crunch occurred. Nervous

I expect a U.S. hard landing and a recession; I expect that this financial turmoil is going to persist and it will be a vicious circle where the real economy gets worse and the financial markets get tighter and vice versa, the tightening of financial conditions leads to a slower economy.

corporations observing the widening of credit spreads, the uncertainty about the future and about markets, now also see a situation in which consumption is retreating, resulting in unsold goods and a further buildup of inventory. In this environment, the rational response when making future investment decisions, Roubini hypothesizes, is to slow investment growth close to zero if not reverse it altogether. And

once that happens, one would expect to observe slowdowns in production, in investment, and in employment. While the corporate system as a whole remains strong, Roubini cautions that the very low rate of corporate defaults witnessed last year could have been due to the “easy credit” conditions in the market—corporations that would have otherwise gone into Chapter 7 or 11 bankruptcy essentially restructured out of court financed by private equity money, hedge funds, and others. The widening credit spreads and tightening of conditions means that an increasing number of these troubled corporations will see difficulty given the repricing of risk throughout the system.

Turmoil in the financial markets

The credit crunch that has given rise to the higher cost of borrowing for both firms and consumers has now spread and, Roubini observes, caused a meaningful and significant seizure of liquidity in a wider range of credit markets. In recent weeks, following repeated measures taken by central banks to provide liquidity to the markets, there have been signs of stabilization. However, Roubini does not foresee a return to normal conditions in these markets; rather, he believes this crunch will persist over time, and in comparison to the Long-Term Capital Management (LTCM) crisis in 1998, this one will be both more severe and more persistent. He reasons that the 1998 crisis occurred against a backdrop of robust economic conditions—strong economic growth, high productivity growth, and an Internet boom. At that time, it was much easier for the Fed to coordinate a rescue and resolve the collective action problem because of the small number of participants affected. Today there are hundreds of institutions with exposure to asset-backed commercial paper so the coordination problem is going to be much more difficult. Roubini warns that the biggest difference today is that, in addition to the liquidity crunch, there are meaningful solvency issues. He explained that financial distress threatens not only U.S. households, but also subprime (and non-subprime) mortgage lenders, home builders, and hedge funds.

The Fed to the rescue? The solvency concerns also lead Roubini to believe that the Fed's easing of monetary conditions will likely not resolve the problem the way it did in 1998 when the primary issue was focused on liquidity.

He reasons the Fed will still be concerned with keeping inflation in check and will be wary of creating conditions that engender moral hazard, and, therefore, it will not aggressively ease the way it

did in 2001. And even in 2001 a hard landing was not avoided; there were two quarters of consecutive negative growth characterized by a glut of capital goods, which consequently, took time to work out. Today, instead of a glut of capital goods, there is a glut of housing, automobiles, and consumer durables to work out. So, to Roubini, the idea that the Fed's easing is going to resolve that glut quickly is wishful thinking; it is going to take a lot of time to work out. In his view, similar to 2001, the Fed will be unable to avoid a hard landing given it faces a new kind of potential crisis stemming from the new world of financial globalization and of securitization.

“I am not sure that the Fed easing is going to resolve the problem the way they did in 1998 because there is an element of insolvency rather than liquidity.”

“I do not think what the Fed is going to do is going to be enough because it is going to be probably too little too late.”

While acknowledging that the Fed's easing of money conditions would serve to ease conditions of tightness for regulated institutions such as banks, Roubini cautioned that the credit crunch is affecting not just the

banking system, but also other unregulated institutions, such as hedge funds and investment banks. He postulated that the open market operations undertaken by the Fed have been ineffective in getting money to the parts of the credit system where the crunch is more severe, which leaves a more fundamental problem that will have to somehow be addressed.

What's going on in these markets? Roubini observed that with the recent market turbulence, many assets have now become difficult to value, and this is so for a number of reasons. First, given the situation of illiquidity, it has become increasingly difficult to sell these assets—there is no market for them, and so it is not easy to attach a value to them. Second, these are all new instruments; they are complex and unconventional, and from the beginning they were never widely traded. And there is an underlying concern that unless the current market conditions are altered to make these instruments more widely traded, then, even in the best of times, there will be problems in pricing them. Roubini noted the widely accepted benefits of financial globalization and securitization, but pointed out that they contributed to a financial system in which market participants placed too much emphasis on collecting fees while packaging and moving the assets on to other participants without paying due regard to the risk inherent in some of these assets. Roubini concludes that an important fundamental problem seems to exist in that given these market conditions, regulators have acquiesced without any attempts at constraining this behavior.

Decoupling from the United States

Roubini closed his talk with some thoughts on whether the rest of the world would decouple from the U.S. as it edges closer to recession. Noting that there certainly had not been *financial* decoupling, he said believes that the question of *real* decoupling depends on whether a

“I am not expecting a global recession, but a more significant slowdown of global growth than the one that people are currently pricing.”

soft-landing or hard-landing scenario plays out. Roubini cited the April World Economic Outlook in this regard, saying that if there is a soft landing in the U.S. economy, growth conditions in China,

the BRICs and other emerging markets, Europe, and the rest of the world, are sustained enough such that there may be some slowdown but not a meaningful impact. However, should his scenario of a hard landing materialize, then the notion that the rest of the world is going to decouple from the United States becomes less realistic. Roubini does not expect a global recession, but does believe that there will be a significant economic slowdown that will be transmitted via trade, financial, and exchange rate channels.

What's in store for the major players? Despite China's accelerated growth in the face of the slowdown in the United States, Roubini sees problems ahead for the Chinese economy given that any U.S. recession would be a consumer-led recession, and, since China essentially produces and exports consumer goods to the United States, that is an important channel of transmission. If China sees a meaningful slowdown of growth, then East Asia, which increasingly produces imports for China to assemble, will suffer the effects of a U.S. recession as well despite the change in the structure of trade within Asia. And at that point the fall in demand for commodities hurts commodities exporters in Asia, Latin America, Africa, and elsewhere. For Europe, which actually now has a cyclical structural recovery, there is uncertainty over whether the euro's growing strength will begin to seriously harm European competitiveness. In the case of Japan, quarterly growth was estimated at being negative even before the financial market turmoil, with the country oscillating between inflation and deflation and between growth and recovery over the past several years. Given that most of Japanese growth has been driven by net exports rather than domestic demand, which continues to be weak, a recovery in Japan is again called into question.

Looking at emerging markets (EMs) generally, Roubini acknowledges that those EMs that followed the advice of the IMF and others and undertook major macroeconomic, financial, and other reforms during the past decade appeared to be in strong positions. He said their earlier reforms would serve to make them less vulnerable to future crises. However, given the benign global economic conditions enjoyed by EMs over the past decade, it would be naive to believe EMs would remain unscathed if a U.S. hard-landing were to materialize. Lower U.S. growth, lower global growth, lower commodity prices, widening credit spreads, and greater risk aversion would pose formidable challenges even to the most resilient of EM economies.

Glenn Gottselig, IMF External Relations Department