

Our Interview with Nouriel Roubini

Robert Huebscher
September 16, 2008



Nouriel Roubini is a Professor of Economics at New York University and chairman of [Roubini Global Economics](#), a highly popular economics web site. He is known for his often-prescient economic forecasts, most notably in 2006 of the current credit crisis and housing market collapse. Roubini, whose alarming forecasts have earned him the nickname “Dr. Doom,” has been called on to testify before the US Congress and the Council on Foreign Relations and worked in the Treasury Department under President Clinton. He was recently profiled in *Barron’s* and the *New York Times Magazine*.

We interviewed Professor Roubini on September 12, 2008.

In regard to the GSE bailout, you have written that “This bailout plan has mostly lousy features that exacerbate the moral hazard of this government intervention and the overall fiscal costs of such intervention.” Can you elaborate?

The GSE bailout should have wiped out the common and preferred shareholders, as well as the subordinated debt holders. It did not. The way it is structured, the common shareholders, for example, could see a massive gain down the road. A purpose of this bailout should have been to provide market discipline, and without wiping out these shareholders that is not accomplished.

This is going to be very expensive for the government. They have put in \$300 billion of public money. Given this, the common shareholders should not have gotten a penny. Wiping out these shareholders would have triggered credit default swap (CDS) defaults, but these defaults have been triggered anyway. The government structured GSE bailout was considered a credit event. It doesn’t make a difference; the CDS payments still must be worked out.

“This is going to be very expensive for the government. “



The GSE bailout does not resolve the fundamental problem of the pending insolvency of hundreds of banks, which will be the byproduct of homeowners defaulting on their mortgages.

The GSE bailout was botched.

You estimate that the cost of the GSE bailout will be \$250-300bn (roughly equal to the cost of the 1980s S&L bailout in current dollars). Can you explain your assumptions behind this calculation?

I have to make certain assumptions, because we don't have 100% knowledge of the GSE's assets and liabilities. We know the gap between these assets and liabilities is approximately \$300 billion, and the government has committed \$100 billion of capital to each institution.

To determine the ultimate cost of the bailout, we must make assumptions about the value of the assets and the ultimate amounts of any writedowns. We have estimated that the assets of the GSEs are worth about 5% less than their face value of \$6 trillion, which is how I arrive at a cost of \$300 billion.

In their portfolios, the GSEs have approximately \$300 billion of subprime and Alt-A loans. A lot of these are going bad. On conforming mortgages, given the downturn in housing, we expect significant default rates. A 5% default rate on the overall portfolio is not unlikely.

You have also forecast that the GSE bailout will push interest rates higher. Can you explain this?

This will happen over time. We have eliminated the implicit guarantee of these institutions, and made that guarantee explicit, effectively nationalizing them. We have added \$6 trillion of liabilities to the government's balance sheet. Of course, we have also added the GSE's assets, and the net increase is the \$200-300 billion I discussed earlier.

n that will expand the deficit to 10% of the GDP. This deficit increase will be funded through an issuance of government debt, which could lead to a downgrade of US Treasury securities. "

The US government is assuming a lot of new liabilities. In addition to the cost of the GSE bailout, this includes the cost of the Bear Stearns bailout, the Frank-Dodd bill, the new lending facilities, a low Fed Funds rate, etc.



We are facing a recession that will expand the deficit to 10% of the GDP. This deficit increase will be funded through an issuance of government debt, which could lead to a downgrade of US Treasury securities. Over time this will push interest rates up.

Our deficit is now \$140 billion, and in 2008 it is forecast to be \$389 billion. By 2009 it is forecast to be \$490 billion, and I believe it will be significantly higher due to the recession. [Note: this forecast of \$490 billion represents 3.3% of GDP.] When you add together the costs of the credit crisis, it is not surprising that people like Bill Gross of PIMCO forecast deficits of \$800 billion.

The US deficit is completely financed abroad, through sovereign wealth funds, central banks, and foreign investors buying US debt. The fraction of US Treasuries held by non-US residents is now more than 50%.

You have estimated the total cost of the credit crisis to be at least \$1.5 trillion. Can you provide the assumptions behind this estimate? If, as you have indicated, the US taxpayer will end up bearing the brunt of this bill, what effect will this have on inflation and economic growth?

The credit loss number is a moving target, and very little has been "fiscalized" (written-off). In February of this year, my estimate was \$1 trillion. Then I said it would be \$2 trillion. People said I was crazy. But then the IMF came out with their estimate of nearly \$1 trillion, Goldman estimated \$1.1 trillion, UBS estimated \$1 trillion, Paulson estimated \$1.3 trillion, and the hedge fund Bridgewater estimated \$1.6 trillion. So I was vindicated.

The ultimate cost of the credit crisis depends on the degree of contraction within the economy. I am confident that \$1 trillion is the floor.

Most of the writedowns we have seen so far – approximately \$300-350 billion - have been related to subprime mortgages. We have yet to see the writedowns that will come from Alt-A, commercial, and real estate loans, credit card debt, student loans, municipal and corporate bonds, and CDS. When you add all that up, it is not difficult to arrive at the estimates I have provided.

As many have said, this is not a subprime problem; it is a generalized and severe credit crisis. We will see several hundred banks go bankrupt.

The next wave of writeoffs will come from homeowners walking away from their mortgages, when their mortgage exceeds the value of their house. I



estimate that the cost of these “walkaways” will be \$300 to \$400 billion, on top of the subprime losses already experienced.

Will the government allow Lehman Brothers to fail?

Lehman is not worth a penny. I believe Lehman is insolvent.

The government is trying very hard to find a buyer. The question is whether Lehman is worth anything. Lots of assets are impaired. I expect that Lehman has a negative net worth, apart from its franchise value. If nobody buys Lehman then they will collapse. If there is a Chapter 11 bankruptcy, then we will have a run on the system. So, hopefully it will be bought for its franchise value.

“Lehman is not worth a penny. I believe Lehman is insolvent.”

If that doesn’t happen we have a problem. The government does not want to do another Bear Stearns. I expect to see a buyer without a formal government subsidy. The government has already subsidized the banking system in a myriad of ways, starting with the lowering of the Fed Funds rate.

You have written that “Barring further upsets related to the economy, financial sector or housing market, the GSE bailout is a positive for equities. Optimistic analysts believe the recession's end is as near as year-end and so is the stock market bottom that usually precedes the end of recessions. In more pessimistic scenarios, stocks will continue to languish with a stagnant U.S. and global economy in 2009.” Which camp are you in – the optimistic or pessimistic one?

I am a pessimist. We are in for a severe 18-month recession, which started in the first quarter of this year. This is the most severe crisis since the Great Depression. When there is a recovery, it will be short and weak.

The FDIC has only 117 banks on its watch list. Independent analysts, who make their living compiling and analyzing thousands of data points on the banking system, have estimated that 8% of the 8,500 banks, or about 700 banks, should be on the FDIC watch list. IndyMac was not on the watch list until June of this year, a month before it went bankrupt. The list is too short compared to the severity of the crisis.

On top of this, the FDIC is running out of money and will need a big recapitalization. They have already gone to Congress to ask for more money.



A very conservative estimate is that approximately 110 banks, representing approximately \$900 billion of assets, will go bankrupt. About half of these assets will be impaired, representing a fiscal cost of \$450 billion. It is hard to tell but, as I mentioned, these forecasts are coming from analysts that follow the banking system very closely.

All of us, no matter how good our analysis, must review circumstances to recheck our thinking. Is there anything that would make you more bullish on credit market prospects? In particular, are there specific indicators that we can watch – things that would either verify your prognosis or cause you to reconsider?

I am forecasting an 18-month recession. The Fed, in their model, forecasts that the recession will be 8 months, a repeat of the 1991 recession. This is not the case. It will be more like 18 months, and the reason is the fundamentals are much worse than 1991.

To be optimistic is to say it will be like 1991. That would be a pretty ugly situation, but manageable. A big chunk of the banking system would not be wiped out.

A key indicator will be the health of the banking system, and the number of banks that are wiped out.

Small banks have, on average, 67% of their assets in real estate. These small banks are in small towns, where everything is locally financed. If the city goes – meaning that it suffers a major housing or real estate crisis - then the bank is wiped out. There are 32 regional banks. Right now, Wachovia looks worse than IndyMac. Approximately one-quarter to one-third of these regional banks look bad.

Remember that, in 1991, when home prices fell 5%, Citibank was technically bankrupt, but survived because it got an exception from the Fed. Now home prices have fallen 25%, and will ultimately fall 40%. Citibank has a massive exposure to subprime debt.

Citibank is valuing its CDOs at 60% of face value. But others, like Merrill, are valuing them at 20 cents on the dollar. There is lots of fudging going on. Banks are making assumptions on their CDO portfolios to get

“There is manipulation and the Fed is going along with it. The fudging and forbearance is massive. You can’t believe any of the statements you are seeing from the financial sector.”



their desired level of writedowns. There is manipulation and the Fed is going along with it. The fudging and forbearance is massive. You can't believe any of the statements you are seeing from the financial sector.

What do you believe are the critical policy decisions — either fiscal or monetary — that the government should take to relative to the economy? Do you see either of the Presidential candidates as more likely to follow this path?

Monetary policy doesn't make a difference. Despite the cuts in the Fed funds rate, inter-bank spreads and credit spreads have not contracted and will get worse. The problem is the looming insolvency of banks, hedge funds, municipalities, and other institutions. Senior government officials realize that monetary policy has made no difference.

Fiscal policy has been similarly ineffective. Of the \$100 billion stimulus package, only one third was spent by consumers. The rest went to pay off consumer debt. It was spent in April and May, and consumer spending has fallen steadily since then. All the data shows we are in a consumer spending recession.

The money spent on the GSEs and Bear Stearns has not resolved the fundamental problem, which is that there are too many homes on the market. The only sensible solution is to write down face value of mortgages. This was done in the Great Depression. It will allow borrowers to refinance at fixed rates. It will avoid foreclosures, which would lead to bank failures and government bailouts.

This has not been done yet. The relief needs to be directed to the borrowers, not the lenders. Fiscal and monetary policies do not make a difference.

The 2008 Frank-Dodd bill goes a step closer to my plan, but is not enough. It relies on banks to voluntarily release the face value of their loans, which I believe is unrealistic. The CDO holders will block certain actions. The claims are too dispersed, and any CDO holder can stop an action. The government must step in and orchestrate a bailout of the borrowers.

McCain's approach is laissez faire, and to allow a disorderly workout of the crisis in the private sector. Obama is more willing to provide public intervention, but has not advocated anything this dramatic. He has been in favor of a proactive government approach. I expect a Democratic President will be more likely to follow the recommendations I have laid out.



www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>