Intelligent Investing Transcript

# Transcript: Nouriel Roubini

Steve Forbes, 01.24.11, 6:00 AM ET

**Housing Double Dip**

**Steve Forbes:** Nouriel, good to have you back again. And before we get an update from you, I just want to promote your book on how to cope with the crisis and get a crash course. And while the economy's maybe potentially crashing, your book went up in terms of sales. Congratulations.

**Nouriel Roubini:** Oh, thank you. It's a pleasure being back with you and having this dialog today.

**Forbes:** As a writer myself, I envy your success.

**Roubini:** Thanks.

**Forbes:** Well, I have to start off--over the holidays you bought a very nice apartment in New York for $5 million or so. People are wondering, is that a sign the market is turning or you just found something you liked and bought it?

**Roubini:** Well, my view on housing is that actually the housing sector is double dipping. Of course you can find a buy at a price much lower than listed, then it is a buy. But if you're looking at the macro data, where in the spring of last year, a time where prices were going up and demand and supply was increasing, but that was all driven with the fact with these first-time homebuyer tax credit.

So anybody who wanted to by a home, bought it by April. As soon as their tax credit expired, demand collapsed, prices started to fall again. So demand is falling, supply is increasing because there is a shadow inventory of millions of not yet foreclosed homes. Therefore, prices are going to fall even further.

So if there is one sector of the economy I would say that is already double dipping, that certainly is the housing and real estate sector. So unfortunately, what is locally working might not be at a macro, national level still working.

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**Forbes:** What kind of bargain did you get?

**Roubini:** Well, you know, the price I got it was almost 30% less than what was listed. So even in New York, essentially prices are effectively 30% below what they were before. That is exactly the cumulative fall in home prices we've had at the national level.

**Forbes:** You mentioned housing. Commercial real estate has been a shoe that people have been expecting to drop now for over two years. Is that going to drop? Or are the banks going to find a way to absorb that?

**Roubini:** In some sense, the problems of the commercial real estate have not been resolved, either. Price-wise, actually, commercial real estate has fallen in price level more than housing. It's 40%, as opposed to 30%, based on what is the index of commercial real estate prices.

Many properties are also deeply underwater. You have about $2 trillion of mortgages or exposure, half of it has been securitized. Most banks are holding this stuff, still 100 cents on the dollar, on their books, even it's worth more like 50, 60 at best. And the Fed has decided to use regulatory forbearance to fudge it, to pray and delay, extend and pretend.

**Forbes:** Right.

**Roubini:** And these problems have not been resolved. A lot of this exposure, actually, is among the smaller banks or the medium sized regional banks. And if they're to write down these assets, the capital losses will be significant. So for the time being, it's kicking the can down the road and hoping that maybe prices start realizing the recovery. But there is such a glut of capacity throughout the country that I think that, you know, we're going to stay in this slump for quite a while.

**Get Out Of The Slump**

**Forbes:** What would it take to get out of the slump?

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**Roubini:** Well, in the case of residential real estate, I would say prices and quantities have fallen so much from the peak, that probably they are close to the bottom. But the trouble is that you have millions of houses that are deeply underwater. 12 million of them already underwater today. And about another 8 million have a mortgage with a loan to value ratio between 95 to 100%.

That means that the 5% correction in national home price--something that I expect--is going to put another 8 million houses underwater. That means 20 million out of the 50 that have a mortgage, or 40% of houses with a mortgage, are going to be underwater.

And I think that a good chunk of the household sector is effectively insolvent--is buried under a mountain of mortgage debt, credit cards, auto loans, student loans, personal loans. And once you have such a massive problem, you cannot resolve it case by case, household by household. You need to have something of an across the board reduction of that burden to restructure just the face value of these mortgages.

Now you can convert, like we do for corporate restructuring, some of that debt into equity if you reduce the face value and then you make the creditor effectively a shareholder in the house by giving them the upside to warrants. So maybe a solution would be like in corporate restructuring, to convert some of these debt into equity so that at least if the prices rise again, there'll be some of the upside for the creditors. But we need to do something more significant than we've done so far.

**Forbes:** Why have the government efforts to do something about housing been such a failure so far?

**Roubini:** Well, in some sense, we've done too much, in some sense, we've done too little. You know, if you need an across-the-board reduction in the face value of the mortgages, some legislative action has to be taken to induce banks or induce the creditors to take these kind of losses. I think that the government has been partly resistant because of a moral hazard problem.

If you start giving debt forgiving to some households and maybe incentivize others who are paying their mortgages now to talk away from them. So I think that some people senior in the White House have told me that that's their concern, that you have a moral hazard problem that you have to deal with.

I think there are ways of dealing with that. You could say anybody who has defaulted up to a certain date will get his debt reduction, after that, not. You can make it mean tested. And there are ways to limit that moral hazard problem. But back in the thirties we create an institution that took over all the mortgages that reduce the face value, converted them into longer term, lower interest rate debt, and people stayed in their homes. And they were able, eventually, to pay it back. If we don't do something radical probably we'll have this kind of case by case process are going to take decades to resolve. And the cancer in the housing is going to stay with us.

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**Economic Growth**

**Forbes:** Are you surprised at how relatively strong the U.S. economy is? I mean you've been fearing a double dip recession. You've been very cautious about the recovery.

**Roubini:** Yes.

**Forbes:** And yet, we seem to be a mode of 3 to 4%. Not good, but certainly not dead in the water.

**Roubini:** Well, you know, I've revised my expectation about U.S. economy growth. I expect that this year, growth is going to be around 2.7%. It's below consensus. The consensus is around 3.2%. But, you know, even if it turned out to be 3.2, 3.2 is barely above potential. Usually after a recession, the economy, for a few years, grows 4%, 5%, 6%.

**Forbes:** Right.

**Roubini:** Because you have a huge upper gap, huge slack in the labor market, takes several years of above trend growth to reduce that slack. So even if the consensus was to be right, it’s really mediocre. The unemployment rate is going to stay, you know, above 9%.

And I think that part of the recovery, the macro data have come out better than expected. That's correct. But let's not forget, we have had a massive fiscal stimulus. We have just added another massive fiscal stimulus by having another $900 billion of tax cuts that are being paid by debt. So we're going to add another trillion dollars for budget deficits. So we're postponing the de-leveraging of the private sector by having even more re-leveraging of the public sector.

And the Fed, after $1.8 trillion of QE1 is doing now another $600 billion of QE2. So the combination of a massive monetary stimulus, zero rates, and fiscal stimulus, is now barely getting us 3% growth if the consensus is right. That's still, I would say, pretty mediocre, given the amount of drug-induced stimulus into the economy.

**Forbes:** Well, let me ask you, then, a question of heresy. Would we have been better off without the stimulus? Would the market have come back on its own and cleared the market and forced people to redo their balance sheets and get back on our feet faster?

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**Roubini:** I'm not convinced by those arguments, in the sense that when there is a collapse in private demand during the financial crisis, demand was falling, consumption, investment, exports. If there hadn't been a stimulus in the terms of reduction in taxes and increasing spending, this great recession could have turned out to be something more like another Great Depression.

That doesn't mean that we have to do a stimulus forever. I think that we are reaching the stage in which the fiscal deficit is huge, over $1 trillion. And we have to start cutting spending and doing entitlement reform. And it might also eventually we're going to have to also raise taxes. We're not going to be able to fill the gap only on the spending side, even if most of the adjustment should be on the spending side.

Otherwise, down the line we're going to have a train wreck. So the right thing was a short term stimulus. And we can debate on whether that stimulus was optimal or not. But the situation was a collapse of confidence. You need the debt, otherwise it would become even worse. But now, you know, it was never a free lunch. And we pay the consequences now of having rising budget deficit and public debt. And eventually, that's a risk to the economy.

**Equity Performance**

**Forbes:** Why has the stock market done relatively well? And earnings, certainly large companies have done fairly well.

**Roubini:** Well, the stock market has done well because, first of all, it collapsed during the crisis. And even now, after almost like a 70 to 80% recovery in the Dow Jones or the S&P, we're still about, you know, 20% below the peak of October, 2007. And if you're looking over the last decade, the stock returns have been close to flat.

So equity returns have been actually mediocre, both in the last three, four years, or over a ten year horizon. They fell so much that then we have an economic recovery, however anemic. There has been a recover of the stock market. Now, earnings are very good. And they're very good because firms have reacted to this crisis by essentially becoming lean and mean. They have slashed costs, especially labor costs. We lost something like 8.4 million jobs. They've become much more efficient and productive.

So there has been a significant increase in productivity and profitability. The question is whether the thing over the medium term is going to be sustainable. Because a process through which you are just reducing real wages implies that there is going to be anemic labor income growth. And if there is anemic labor income growth, eventually, consumption growth is going to be also constrained.

So let's not forget that if you exclude taxes and transfer payments, before those adjustments from the government, real income growth has been extremely mediocre for the last couple of years. So it's the public sector is now sustaining the income growth and the spending growth of the private sector.

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**Forbes:** So you're not impressed with the growth of private incomes in the past year or so?

**Roubini:** If you look at the data excluding transfer payments, and we are just giving another $900 billion of those transfer payments over the next two years, actually, real wages have been close to stagnant. They've been recovered but in a relatively mediocre way.

So with have also a fundamental problem of now probably structural unemployment rates. You know, the unemployment rate went close to, you know, 10%. Now it's still in the mid-9%. Even if we generate 150,000 jobs this year, as I expect, that's just enough to absorb the increase in the labor force. That means unemployment rate is going to remain high. That's going to become a social and political problem over time.

**Forbes:** The stock market, would you advise people to stay away or what?

**Roubini:** No, I would not advise to stay away. I would say that, you know, this year probably. The last year was a period of risk on and risk off. Risk was off because of the Greek crisis and other kind of global shock. And then after QE2 and after the decision to do another fiscal stimulus, the market kind of rallied.

There is a recovery. It's U.S., it's global, it's mostly also in emerging markets. So returns to equities could be positive this year. But I see a number of potential downside risks to the U.S. and the global economy. For the global economy, I would say the biggest risks are coming from those in the Euro zone, where now the contagion has spread from Greece, to Ireland, to Portugal. Spain could be next. And Spain is too big to fail, too big to be saved, given the official resources.

Even the U.S., where actually I see growth close to 3%, I would see at least four potential down side risks. One is high unemployment rates staying with us. Two, the housing and real estate double dipping. Three, the state and local governments, many of them are near bankrupt. And four, the fact that we are still doing nothing about our federal deficit problem.

Now the bond vigilantes have woken up in Europe. They've not yet woken up in the United States. But if you keep on running a trillion dollar budget deficit plus for as far as I can see, eventually, even in the U.S., those vigilantes are going to wake up. Long rates could go up. And that could crowd out the recovery. So there are downside risks.

**Forbes:** So you're not buying U.S. treasuries long term?

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**Roubini:** Well, you know, you have to be cautious. You know, there are some reasons why yields might not increase as much. If growth is still weak, if there is more QE2, if the Fed fund rate is at zero, if there is not much inflation. But I would say that that's on one side, keeps yields from rising too much so far. On the other side, if we have a large budget deficit, all financed either through debt, or if you monetize it, eventually, once the upper gap and the slack labor market is gone, you could have increasing inflation expectations. Both factors could lead, over time, to an increase in long rates that would crowd out the recovery. That's a risk.

**Muni Bond Bubble**

Forbes: You mentioned four things to worry about in the U.S. economy. Let's focus a bit on the one that seems to be at the forefront: The municipal bond market. Do you think that there's going to be a further fall in municipal bond prices? Do you think the vigilantes are not going to buy bonds from, say, Illinois, which wants to finance its debt, state debt, by issuing more bonds?

**Roubini:** Certainly I would say that the condition of state and local governments are extremely serious.

**Forbes:** Is that a bubble?

**Roubini:** Well, more than a bubble, I would say, you know, there's a fundamental fiscal problem. You know, think of it. Greece is only 3% of the Euro zone GDP, while California alone is one seventh of the U.S. GDP. And the trouble is not just in California. It's California, Arizona, Nevada, Florida, Illinois, New York, and a good chunk of U.S. states.

And I would point out the following thing: In 1991, after a relatively mild housing bust where home prices fell only 5%, and you had a mild recession that lasted only eight months, muni bonds were trading, at that time, like junk bonds, because the rate of default by local government was spiking significantly. Now I do not believe that we're going to allow any major state to default. Because, as I said, if Greece was too big to be allowed to fail, California or Illinois are even bigger than that.

But certainly the level of the local government, local municipalities, local agencies and so on, you could see a significant increase in those default rates will have a negative effect on muni bonds and on spreads on them, as well. So I think that is one of the major risks we're facing right now.

**Forbes:** Given the mood of Congress, there's certainly no mood there now to bail out states. Do you think the Federal Reserve would step in and do the equivalent of what the European Central Bank did with the sovereign debt in the Federal Reserve--buy Illinois bonds are California bonds?

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**Roubini:** I would not completely rule it out. You know, until now, we have back stopped the states through the federal budget, you know, transfer payments on a variety of sorts to make sure that they don't blow up. At this point, as you point out, the political willingness to do more of it is limited. And if therefore, some of these big states were to get into serious trouble, I would not exclude.

You know, the Fed started buying, you know, RMBS as Fannie and Freddie agency debt, treasuries. During the crisis, bought even toxic assets of Bear Stearns and of AIG and you name it. You know, they could go along the lines, if there are financing pressures like the Europeans, of trying to make stop all the state governments that are in trouble.

If Congress doesn't do it, there'll be some pressure on the Fed to do that. That might be a version of QE3, after QE2. QE1 was mostly agencies--Fannie and Freddie, QE2 was treasuries mostly. QE3 could be state and local debt.

**Will Euro Zone Split?**

**Forbes:** Going to Europe for a moment, do you think the Euro zone, as you've indicated before, will split up?

**Roubini:** I would certainly think that the probability that over the next five years some of the weaker members might decide to exit is rising, probably more than a third probability. And even more likely, even before there is a breakup of the monetary unit, I think there's going to be of course a restructuring of the public debt of some of the sovereignties that are effectively insolvent. Specifically I would point out the cases of Greece, where the public debt, even under the IMF, is going to go toward 150% of GDP, or the case of Ireland, that has taken so many of the liabilities of the banks on its own balance sheet of the government, and now you are breaking the back of the government.

So I would say high likelihood of restructuring of public debt and also of the unsecure senior claims on the banks, as well. That's very likely. Where there is going to be a breakup of the monetary unit will take longer. But all the restructuring of private and public debt, I think it's a--

**Forbes:** Do you think the markets have priced in a restructuring of some of the sovereign debt in Europe yet?

**Roubini:** In some cases, yes, because the Greek debt is already trading at, you know, 60 or 50 cents on the dollar, depending on maturities. But the markets are still believing the European Union is going to wait maybe until after 2013 to do some of these restructurings. In my view, these restructurings are going to occur much sooner than 2013. Otherwise, it will become disorderly if you postpone it over time.

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And there are ways actually to do restructurings that are orderly, that minimize the losses for the creditors. For example, countries and sovereignties like Pakistan, like Ukraine, like Uruguay, did orderly restructuring of their public debt, where they pushed the maturities out by ten, 20 years. They capped the interest rate on the new debt below market rates. And they kept the face value 100 cents on the dollar, thus allowing the creditors to pretend they still want it.

**Extend And Pretend**

**Forbes:** So would this be a version of extend and pretend, taking Greek debt, putting a 50 year maturity on it, cutting the rate, but pretending for bank balance sheets you can keep it 100 cents on the Euro?

**Roubini:** There's an element of, yes, extend and pretend. Because rules for the banks allow banks to hold today--the debt is in their banking book at 100 cents on the dollar, even if the market value is much lower. So as long as you don't reduce the face value of the debt, then they can keep it this way.

But we said this story before. When there was the Latin America debt crisis, the resolution was the Brady Bonds. There were two types of Brady Bonds. One was the par bonds for those banks that pretended or needed to pretend that the debt was worth 100 cents on the dollar, and the others were the market investors who got the discount bonds. It doesn't matter. From a net present value point of view, if you push out maturity, then capable the interest rate, you're imposing a loss. Even if the face value is 100 cents of the dollar. So the two things are equivalent. But for regulatory purposes, some institutions--banks, pension funds, insurance companies--might prefer a par bond that allows to at least not having the debt right down and the capital loss taken right away.

**FinReg In The Right Direction**

**Forbes:** Financial reform bill. A lot of verbiage that's not going to accomplish very, very much except a lot of new rules. How do you feel about it? Do you feel it addressed problems of capitalization, leverage, and some of the other problems you saw?

**Roubini:** It goes at least in the right direction. I wouldn't say that all they have done is not. You know, having more capital, having more liquidity, it's helpful. I do agree that you have to make the system incentive compatible. Regulations alone are not sufficient.

For example, if traders and bankers are taking too much risk in leverage, there is not going to be any CEO that's strong enough, or board, that can essentially supervise and monitor the actions of thousands of separate P and Ls. And in every bank, every trader and banker is a separate P and L. So you have to make sure that their behavior is consistent with long term shareholder value.

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And to me, maybe reforms of the compensation system might be the right way to go. Something that actually Dodd-Frank doesn't do. Meaning we have a bonus model in which it incentivizes traders and bankers to take lots of risk, lots of leverage. If they get it right, they make the money. If not, it's the institution that loses money.

If you had a bonus/malus model where you don't get your bonus until exposed, we see whether your investments, on a risk adjusted basis, were profitable, maybe you can incentivize them to behave better. So those are the kind of things that you have to do, apart from regulation, to make sure that people behaving ways that are consistent with the objective.

**Forbes:** Do you think there's any possibility of the U.S. or the world going to a gold-based monetary system?

**Roubini:** I don't think it's likely to happen. You know, economists discuss the pros and cons of it. And different people have different views. But if you ask me, separate from the normative question of whether that will be desirable, whether that's likely, I would say it's not very likely.

You know, even countries that, say, experience high inflation if not hyperinflation, you know, from Argentina to others, eventually they stayed with fiat currencies. So you could make an argument--that I don't agree with--about going back to the gold standard. There are pros and there are cons. But if you're asking me, "Is it likely that that's going to happen," I would say, "No."

Of course gold has a role as a reserve currency; it's more of a reserve currency than a metal. And that role is increasing right now as people worry, on one side, about inflation, on the other side, about global systemic financial risks. And usually gold tends to do very well in periods of time of high inflation or risk of global financial disaster. And that's part of what's behind the rising gold prices. So certainly a well diversified portfolio of both central banks and private investors includes gold. But I don't think that gold is going to replace any time soon fiat currencies.

**Chinese Trade Tension**

**Forbes:** Talking about currencies: China. Are you worried about the trading system unraveling, or do you think there's still sufficient belief in governments that we must preserve at least the movement toward a little bit of more free trade?

**Roubini:** It's a mixed bag, you know. On one side, of course, given the financial economic crisis, have been significant protectionist pressures, and given that China is not very willing to let this currency appreciate, that creates also currency tension, creates trade tensions. You know, we are in a world in which 10% for China is their growth rate, and 10% for the United States is an unemployment rate.

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We have 10% unemployment in U.S. and 10% growth in China. And the China, I think, its currency appreciates only gradually. That's a source of the trade tension. I'm not in favor of trade protections. I think it will be very dangerous.

But I think that, you know, the various countries in the world have to cooperate, because some of the adjustment in trade balances will occur, in part, to change in relative prices. And China is resisting that adjustment, in a way that actually is becoming negative for China. Because their willingness to move the currency means that monetary policy's too loose. There is excessive overheating of the economy. There is asset inflation. There's credit bubbles. There's actual inflation.

And actually, letting the currency appreciate at a slightly faster rate may allow China to control those inflationary pressures. So maybe the Chinese this year are going to start letting the currency appreciate at a slightly faster rate.

**Forbes:** Nouriel, thank you very much for being with us.

**Roubini:** It was a pleasure being with you today.

**Forbes:** Thank you.

**Roubini:** As usual. Thanks.