

Addressing 'Stagdeflation'

With Nouriel Roubini

Nouriel Roubini, professor of Economics at the Stern School of Business, New York University, christened Dr.Doom by the US business media, is not given to wearing rose coloured glasses. He does not see the severely strained global economy to be mending for a while yet. And this, to him, comes as no surprise. For, Roubini through his scholarly work at NYU and as the founder-chairman of the highly rated and widely respected RGE monitor (www.rgemonitor.com) has long been pointing to the looming negative trends. Governments, he assesses will have to be confronting "a strange beast called 'stagdeflation'" in the coming times.

In this wide, ranging conversation with **Charles Krusen**, the well-regarded CEO of Krusen Capital Management, New York, exclusively transcribed for *BSensex*, Roubini describes possible measures to prepare for the coming challenges.

Charles Krusen (CK): The US is trying to spend its way out of the current crisis, whether through rescue plans for the financial industry or by cutting taxes and increasing spending to promote consumption. What debt-to-GDP ratio is ultimately sustainable and at what cost?

Nouriel Roubini (NR): It's highly likely now that we will realise USD2-3 trillion of public debt in the next few years, implying a 20 per cent increase resulting from a massive issuance of debt combined with taking the liabilities of FreddieMac, FannieMac and others onto the government's balance sheet. This may lead eventually to a downgrading of the country's triple-A rating status.

On top of that, the ability and willingness of non-US residents to finance our fiscal and current account deficits will shrink. For the past few years, most of the US budget deficit has been financed by non-residents who are not necessarily US friends and allies but rather countries like China, Russia or unstable petro-states. These creditors' ability to fund US debt will decrease dramatically because of the large fiscal deficits emerging in half the world – in

China, Japan, Europe and other countries that are in trouble. That might imply that down the line we will need to raise interest rates.

So while in the short run we see rates falling because of investors' flight to safety, a future tsunami of public debt may push real rates higher over time.

CK: Can you give us your outlook for both deflation and inflation in the US?

NR: I'm not worried about inflation in the short term with demand falling while supply is increasing and also because there will be a surge in the unemployment rate. Commodity prices are going to fall even further. Markets around the world will see global stock deflation and a period of economic stagnation. So I worry more about deflation and central banks being forced to raise real interest rates and ending up in liquidity traps.

I am concerned about inflation in the medium term because we don't know whether a very large fiscal deficit is going to be monetised over time or financed with public



debt. If the latter, it won't be inflationary because we're going to have to raise taxes or cut spending eventually. But if part of this fiscal account deficit were to be financed by printing a lot of money then we're going to get medium-term inflation.

The benefits of monetising include wiping out some of the real value of the liabilities of American households, government, and corporations. So there is a temptation to use inflation. But if the inflation expectation genie were to get out of the bottle, with inflation rates going to high single digits or even double-digits, it would take time to get the genie back into the bottle. And that would be very costly. The temptation is that the inflation path could be perceived as the cheapest way politically of reducing our liabilities. But it would be a dangerous way of doing it.

Finally, a lot of our liabilities are variable rate, not fixed rate nominal debt that can be wiped out by inflation. You can wipe out the value of the fixed rate ones, but not those that are variable rate debt. So even our ability to have inflation wipe out our debt will be hindered by this short-term variable rate debt.

CK: Are we going to have to restructure our consumer-driven economy, especially given that we have a trade deficit?

NR: The US consumer is literally bust. Data suggest that real consumption is in free fall. The US consumer is shopped out, saving less, debt burdened, and now hit by falling home and equity prices. Falling home prices mean that you can't use your home equity as an ATM machine and borrow against it. So home equity withdrawals have collapsed from several hundred billion dollars several years ago.

We have a huge amount of debt in the housing sector. Debt servicing ratios are rising from 11-15 per cent. There is now a credit crunch spreading from sub-prime to real prime to credit cards to auto and student loans. We have almost 11 months of falling employment and the unemployment rate is going to accelerate, perhaps to as much as 9 per cent.

So you have to forget the consumer. US consumption is really in free fall at this point. It's desperate.

CK: Staying on that theme, can you give us an idea of what you think will happen for the dollar and also for gold over the next year or two?

NR: In the short term the dollar may continue to strengthen because of cuts to interest rates and expected weaker growth in Europe and Japan as well as the continuing flight to safety and the carry trade. But I think the prospects for the dollar in the next 6-9 months are bearish because we have large current account and fiscal deficits and because the economic collapse in the US is going to be worse than in Europe and Japan – even if things are looking not very good there. The medium-term outlook for the dollar on a trade-weighted basis points to a weakening of the dollar.

Gold is headed down for a number of reasons. In a world of deflation, holding gold as a safe harbor is no longer valid. Another reason is that the bank panic of September/October has passed and people are not as worried about the safety of their deposits. Third, leisure and commercial demand are falling because even the rich cannot afford to buy jewellery.

So I see gold prices going down rather than up as long as the fiscal deficit is not monetised. If the fiscal deficit were monetised, then you'll have a bout of massive inflation and a huge rally in gold.

CK: What is your outlook for the emerging markets? In particular, could you tell us what you think about India?

NR: Emerging markets are in trouble right now because of lower global growth, falling commodity prices, and increasing aversion to risk. All these factors are bad news for emerging markets. Of course you have to distinguish those economies which have stronger fundamentals from those



with weaker fundamentals, but I see a severe slowdown in growth in all of them. For emerging economies, recession doesn't mean zero growth. It means zero to growth that is well below their potential rate, which is closer to 6 per cent.

And in the case of India also, I see trouble. While India is less exposed to world trade than China, it is running very large current account and fiscal deficits and is vulnerable to a sudden stop or reversal in capital inflows. So India is vulnerable, like most emerging markets, to a hard landing.

CK: China's slowdown appears to be more dramatic than had been forecasted. What are your thoughts on that?

NR: My concern is about a hard landing in China with a growth rate that is going to fall from 12 per cent to 6 per cent. The country needs a growth rate of about 10 per cent to continue accommodating the 15 million migrants in the urban manufacturing centers.

My forecast is that even with the fiscal stimulus measures that have been announced, Chinese growth next year is going to be 7 per cent if not lower – only

one percentage point above the 6 per cent mark that represents a hard landing for the economy. I am very worried about Chinese growth and I'm not sure that fiscal actions can be undertaken fast enough to make a significant difference.

CK: What could cause the global economy to completely break down?

NR: We know already that we have a severe global recession in the advanced economies and we also know there is going to be a hard landing in the emerging markets. The question is not whether there is going to be a global recession anymore. It is whether it lasts through 2009 or is more protracted.

That could happen if the credit crunch becomes even more serious. And the global recession could become protracted if the policy responses in the US, other countries and emerging markets are not appropriate to stem the economic contraction. The scenarios I would worry about are those where the credit crunch becomes worse or the policy responses are not appropriate.

CK: If you could give one message to President-elect Obama and his financial team, what would it be?

NR: That aggressive policy actions have to be undertaken very rapidly and on a very large scale – on the order of USD500 billion or more – combined with a much more aggressive recapitalization of the financial system and policies that ease the debt burden of households. Together, of course, with much easier monetary policy by the Fed. Those four things together are necessary to try to make sure this recession doesn't become worse than it is already. The risk is that we face something like Japan faced in the '90s with full-scale economic and financial stagnation. We have to avoid that at any cost.

CK: If you were to put on your rose-coloured glasses – which you don't wear very often – what would the best outcome be?

NR: The most optimistic scenario is one in which the recession in the US ended in the middle of next year rather than toward the end of 2009; that very aggressive policy actions lead to the contraction being shorter than otherwise. And somehow the US consumers turn out to be more resilient in the end than I expect them to be. And that we reach the bottoming out of housing prices sooner rather than later.

And in this scenario I also see policy action abroad that can shorten the length and severity of the global economic contraction.

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