EMERGING MARKETS

Interview with Nouriel Roubini

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Fears have grown this week that we are on the verge of a new global financial crisis. What's your view?

In my view there is a high likelihood that there is going to be another global financial crisis. My data suggests that most advanced economies are already entering a recession. We're not any more in an anaemic recovery, we're not any more at stall speed. We're at the beginning of a contraction. I think there's a contraction already in most of the eurozone, there is a contraction in the US, also in the UK. That's the first point.

The second point is we're running out of policy bullets – monetary, fiscal – backstopping the financial system.

And third, the eurozone is a source of systemic risk. If there is a disorderly situation in the eurozone it's going to be worse than Lehman.

At this point it's not any more Greece or Ireland or Portugal. The contagion has spread to Italy and Spain. In the case of Italy and Spain the critical thing is that even if you believe that Italy and Spain are illiquid but solvent, even adjusting from the reforms, they've lost credibility in the markets. It's going to take them at least a year to regain it.

Therefore you need a lender of last resort to backstop the sovereigns until they regain the credibility to avoid spreads going up and leading to a self-fulfilling run. And there are only a very few options, none of them feasible. One of them is the [eurobonds]. It's going to take at least two years until they can pass that and it's going to be approved by a treaty.

The other option is the ECB doing the dirty job. But the ECB constitutionally, legally, is not allowed to be a systemic lender of last resort for sovereigns.

The third option is to triple the EFSF (European Financial Stability Facility). But they're not even able to pass the current extension of the EFSF. If tomorrow the Germans have to triple the EFSF, that is a political mission impossible.

So my worry is that the EFSF is going to run out of money and then there is not going to be a lender of last resort to backstop Italy and Spain. And that could be a source of a systemic break down of the eurozone, with global financial consequences worse than Lehman.

What can policymakers do now to minimize the inevitable fallout?

I wrote a paper recently in which I have an eight-point plan to highlight the kind of policies which are needed. One, much more monetary and quantitative easing, not just quantitative easing but credit easing. Two, short-term fiscal stimulus in the countries that can still do it. The US, UK, Germany, core of the Eurozone, Japan, it's the periphery that's doing fiscal retrenchment. You have to postpone the austerity. In the short-run, we need fiscal stimulus. We need to provide massive amounts of lender-of-last-resort support to Italy and Spain to make sure that illiquid but solvent sovereigns do not have a self-fulfilling run. We need an orderly restructuring of the debt of governments, of banks, of households that are insolvent. We need to have a massive recapitalization of the European banks through a TARP (Troubled Asset Relief Programme) type of programme for the European banks. We need to support emerging markets by providing monetary and fiscal support to the countries that are going to get in trouble, and to provide support through the IMF and other international financial institutions. We have to provide credit to small and medium-sized enterprises and households that are squeezed. We need to have also an orderly exit of countries that are not going to regain competitiveness in the eurozone, like Greece and potentially also Portugal. And you have to do this in a clear, holistic and front-loaded way. So there are many things that we need to do. I fear that the politicians in the US, in Europe, in UK are not going to have the political willingness to do it in their own countries, let alone coordinate it internationally.

So what's the likely outcome given this policy gridlock in the key countries?

At this point the debate is not whether we're going to have a double dip or not: the double dip has started. The only question is: are we going to have a mild recession that's going to last for three quarters in advanced economies or are we going to have a severe recession and another global financial crisis? The answer to that question depends on whether you can keep Italy and Spain together. It's not even about Greece.

That depends on Germany taking the risk of essentially backstopping Italy and Spain – or the EFSF, e-bond, or the ECB doing the job. Because whichever way you do it, today the German taxpayer is backstopping German debts and the ones of Greece, Ireland and Portugal. But you need now to backstop EU3 trillion of Italian and Spanish debt. That implies that if Italy and Spain are not illiquid but solvent, but they are insolvent Germany takes a huge amount of credit risk. Germany and France could both lose their triple-A status. So there is political resistance to this quasi-fiscal union in Germany and the core of the eurozone.

But if you don't do it, it'll be a disorderly break-up of the eurozone. So you need to go in the direction of a quasi-fiscal union in the sense of providing liquidity support to illiquid but solvent sovereigns that are too big to fail and too big to be saved. That's the key issue.

How quickly are markets likely to turn aggressively on Italy and Spain?

Well Italian spreads are already 500 basis points. Even if the EFSF is approved – because right now the backstop is provided by the ECB but the ECB has said 'it is not my job' – we need three times the EFSF. Once the EFSF is approved, out of the E440 billion, half of it has already been committed to Greece, Ireland and Portugal and to their banks.

So markets are going to look through it and say there are only E200 billion left and we're going to run out of those E200 billion, at the rate at which there is pressure now on Italy and Spain, by the year-end at the latest or by March of next year.

If it takes two years until an e-bond is essentially voted, you have a window of two years or a year and a half in which Italy and Spain risk losing market access without there being an alternative. You need either e-bonds or EFSF or the ECB to do the job. So that's the risk and it's going to happen soon enough.

People are going to see it as soon as the EFSF is approved and people realize that there is not enough money.

This is clearly a European problem with global consequences – but which nevertheless requires a European solution. Is there anything the international community can feasibly do?

Well you have to make an agreement that we need, for example, coordinated monetary expansion among advanced economies. We need a coordinated agreement that we need a fiscal stimulus in all advanced economies, apart from those in the peripheral eurozone that are forced to do fiscal austerity. We need to have a commitment to a mechanism that provides liquidity support to Italy and Spain that is three or four times larger than the E440 billion. We need to have a European plan to essentially recapitalize, Tarp-style, the European banks.

You need to do lots of things that show that you see what the problem is and you're willing to do whatever is necessary to avoid a freefall. You need to do it within the eurozone and you need to do some things on a global basis like the monetary and fiscal stimulus.

I don't think we're going to get there. Tim Geithner went to the [Econfin] minister's meeting [last week] and he was told: 'don't come and tell us what to do, we want fiscal austerity we don't want to recapitalize the banks, we don't want monetary expansion.'

So there is a fundamental disagreement between US, Europe, UK and Japan – even on the necessary policies. That's the gridlock.

So in light of this gridlock, the paralysis among the big decision-making bodies, where is the leadership in this crisis? Where should it come from?

Well we are in a G-zero world in which the US used to impose its own will on the global economy. Today it is under geopolitical and financial stress and the US cannot essentially impose its own will.

So the leadership now has to come out of Germany – either Germany takes the risk, the credit risk of backstopping Italy and Spain, which is a risk, but saves the eurozone. Or if Germany is not willing to do that then you have the destruction of the eurozone.

At this point the Free Democrats [in Germany] are against it and therefore [Chancellor Angela] Merkel will have to do a radical policy change: changing coalition, dumping the Free Democrats and going for a grand coalition either with the Greens and/or the Social Democrats who are willing to take a chance for Europe.

I don't know, however, whether within the CDU there are very different views. Some are more Europhile, some of them are less. It's not obvious they're going to be willing to make that political decision. That's the critical thing that has to happen. So there has to be a change in coalition in Germany to make that option viable and likely.

But there is not much time to do it. Because even if the EFSF is approved – and it's already being delayed – people the next day are going to see through it and see that there is not enough money for Italy and Spain. And we need much more money. That's going to be the key thing. We don't have much time. That's the problem.

How much time do we have left?

We have three months, through the end of the year. Given the current market pressure on Italy and Spain, the EFSF, even if it's approved, is going to run out of money. By the way, the EFSF is not even pre-funded. It has to borrow. It's going to run out of money and then you have the same problem. So markets are going to look through it and realize there is not enough money and they're going to put pressure on Italy and Spain, even if tomorrow the EFSF is approved.

The markets today are telling Italy and Spain we need fiscal austerity and Italy and Spain are doing more of it. Tomorrow, once they do it, there will be an even more severe recession in the eurozone and in Italy and Spain. People are going to say 'fine, you're doing the fiscal budget reduction but now you're spinning into a recession.'

So you're not going to be debt sustainable because you've got no growth. So unless we have a strategy to restore growth in the eurozone in the short run, there needs to be monetary policy easing on a massive scale: weakening of the euro, fiscal stimulus by Germany and the core, backstopping Italy and Spain and doing anything else in terms of infrastructure spending to boost the growth of the periphery that's now spinning into a recession.

Unless all these things happen it's not going to be sustainable. So liquidity support is not enough. You need to restore growth not three years from now, not five years from now through structural reforms, you've got to do it today. Otherwise it's not going to be sustainable. And the eurozone now is spinning into a recession again.

The signs from policymakers are not encouraging. Germany's finance minister was reported to have said that the G20 was largely in agreement that a fiscal stimulus is simply not needed now. What do you make of that?

That's nonsense. The IMF has it right. [IMF managing director] Christine Lagarde has it right. If everybody does fiscal austerity at a time when private demand is falling again you're going to have another global depression. We're going to make exactly the same mistake like during the Great Depression, when we took away the fiscal stimulus too soon. That is a huge risk right now.

Where does this all lead us? The risk in your view is of another Great Depression. But even respectable European politicians are talking not just an economic depression but possibly even worse consequences over the next decade or so. Bearing European history in mind, where does this take us?

In the 1930s, because we made a major policy mistake, we went through financial instability, defaults, currency devaluations, printing money, capital controls, trade wars, populism, a bunch of radical, populist, aggressive regimes coming to power from Germany to Italy to Spain to Japan, and then we ended up with World War II.

Now I'm not predicting World War III but seriously, if there was a global financial crisis after the first one, then we go into depression: the political and social instability in Europe and other advanced economies is going to become extremely severe.

And that's something we have to worry about.

What about the countries in the world with relatively healthy balance sheets? What about the large emerging nations? What should their response be this time? What can China do at this time?

China has to change radically its growth model because it's not sustainable. They talk about increasing consumption, but consumption as a share of GDP has fallen from 50% to 40% to 35%, now it's 33%. And fixed investment has gone from 30% to 40% and now 50% of GDP.

China is going to have in two years its own hard landing. There's so much overcapacity, from real estate to infrastructure to manufacturing that unless they change their growth model to rely more on consumption and less on fixed investment, eventually there will be a hard landing in China. So it's not any more an issue of net exports.

They have reacted to the collapse of their net exports by boosting fixed investment rather than consumption. So they have to radically change their growth model and the sooner they do it the better for them and for the global economy.

Where does that leave China with respect to either a willingness or capacity to react with similar vigour to today's crisis as they did in 2008?

Well, if there is a recession in the G3, China is going to do more monetary, fiscal and credit stimulus. They're going to kick the can down the road for another year because in a year from now they're going to change their own leadership. But that creates even more imbalances because the only thing they know to do is more infrastructure, more real estate, more manufacturing and industrial capacity by the SOEs (state-owned enterprises). So they make the investment bubble even worse and the hard landing is going to be even worse down the line. What they need is radical policies that lead them to save less and consume more. But it will take them 10, 20 years of policy changes to achieve that. I fear they're not going to do it in time.

G20 leaders are telling us that they simply need to keep markets calm until the EFSF is agreed in mid-October. Are they deluding themselves? If we don't get a meaningful statement this weekend what are we likely to see in the markets next week?

The uncertainty, the volatility, the risk aversion is rising. I fear they're not going to reach an agreement along the lines of what I've proposed and therefore there will be more turmoil, more uncertainty, more volatility, more risk aversion. And even approving the EFSF in the current format is not going to be enough. So if it's approved people are going to say 'hey it's not enough money.' Two, there's fiscal austerity but there is no growth. So Italy and Spain are toast unless we have triple or quadruple the amount of official resources to backstop them. So, much more needs to be done and I fear the G20 are not going to say anything meaningful in this regard.

Nouriel Roubini is chairman of Roubini Global Economics

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