Yes, That's $2 Trillion of Debt-Related Losses

Nouriel Roubini, Economist and Professor, New York University
By ROBIN GOLDWYN BLUMENTHAL

AN INTERVIEW WITH NOURIEL ROUBINI: Maybe now somebody will listen. (Video)

LIKE THE EXHORTATIONS OF JEREMIAH TO THE NATION OF Israel before the first temple's destruction, the warnings of economist Nouriel Roubini fell on deaf ears. For the past two years Roubini, a professor at New York University, has cautioned about a huge housing bubble whose bursting would lead to a 20% drop in home prices; a collapse in subprime mortgages; a severe banking crisis and credit crunch; the near-failure of Fannie Mae and Freddie Mac , and a U.S. recession of a magnitude not seen since the Great Depression. So far, this latter-day prophet of doom has been on the mark, though time will tell about the recession part.

A Turkish native who grew up in Italy, Roubini trained at Harvard and later advised the Clinton White House, after his blog on the Asian financial crisis attracted the attention of Washington's economic and political elite. Roubini still publishes the blog -- the RGE Monitor -- and teaches economics at NYU's Stern School of Business. We caught up with him recently at his offices in lower Manhattan, and continued the conversation at Barron's. For his latest predictions, please read on.

Chris Casaburi

"A systemic banking crisis will go on for a while, with hundreds of banks going belly-up." --*Nouriel Roubini*

Barron's: *Unfortunately for the rest of us, you have a pretty good track record. How much more misery lies ahead?*

Roubini: We are in the second inning of a severe, protracted recession, which started in the first quarter of this year and is going to last at least 18 months, through the middle of next year. A systemic banking crisis will go on for awhile, with hundreds of banks going belly up.

Which banks, specifically, will fail?

I don't want to name names, but many, given the housing bust, will become insolvent. Their losses are mounting because they have written down only their subprime loans so far. They haven't started writing down most of their consumer-credit losses, and reserves for losses are much less than they should have been. The banks are playing all sorts of accounting gimmicks not to recognize them. There are hundreds of millions of dollars outstanding in home-equity loans that eventually could be worth zero, too.

So far, we have seen no recession in the technical sense: two consecutive quarters of negative growth in real GDP. Why not?

The definition of a recession isn't only two consecutive quarters of negative growth. The NBER (National Bureau of Economic Research) puts a lot of emphasis on things like employment, and employment has already fallen for seven months in a row. It also emphasizes income and retail and wholesale sales. Many of these things are declining.

Maybe the recession started in January; if you look at the data on gross domestic product on a monthly basis between February and April, GDP was falling. Saying this is not a recession is just a joke. Maybe instead of a 'U' recession and recovery, it will be a 'W,' with a rebound in the second quarter. But by the third quarter, the effect of the government's tax rebates is totally gone, because other forces on the consumer are more persistent and negative.

Which forces, for instance?

The U.S. consumer is shopped out and saving less. Debt to disposable income has risen to 140% from 100% in 2000. Hit by falling home prices, the consumer no longer can use his house as an ATM machine. The stock market is falling and (issuance of) home-equity loans (has) collapsed. We have a credit crunch in mortgages, and gas is around $4 a gallon. Everyone says, 'yeah, that's true, but as long as there is job generation there is going to be income generation and people are going to spend.' But for seven months in a row, employment in the private sector has fallen.

The most worrisome thing is that in spite of the rebates, retail sales in June were up only 0.1%. In real terms, they were down. If people were not spending their rebate checks in June, what will happen when there are no more checks?

Good question. How do you think Federal Reserve Chairman Ben Bernanke has handled the crisis so far?

The Fed's performance has been poor. More than a year ago the Fed said the housing slump would end, but it hasn't. They kept repeating this was a subprime-debt problem only, whereas the problems of excessive credit involve subprime, near-prime, prime, commercial real estate, credit cards, auto loans, student loans, home-equity loans, leveraged loans, muni bonds, corporate loans -- you name it.

The Fed's other mistake was to believe the collapse of the housing market would have no effect on the rest of the economy, when housing accounted for a third of all job creation in the past few years. When the proverbial stuff started to hit the fan last summer, the Fed went into aggressive-easing mode. But it has always been kind of catching up.

What should Bernanke have done a year ago, or even prior to that?

The damage was done earlier, beginning when the Greenspan Fed lowered interest rates in 2001 after the bust of the technology bubble, and kept them too low for too long. They kept cutting the federal funds rate all the way to 1% through 2004, and then raised it gradually instead of quickly. This fed the credit and housing bubble.

Also, the Fed and other regulators took a reckless approach to regulating the financial sector. It was the laissez-faire approach of the Bush administration, and (tantamount to) self-regulation, which really means no regulation and a lack of market discipline. The banks' and brokers' risk-management models didn't make sense because no one listens to the risk managers in good times. As Chuck Prince (the deposed CEO of Citigroup) said, 'when the music plays you have to dance.'

Now the regulators are attempting to make up for lost time. What do you think of their efforts?

The paradox is they're going to the opposite pole. They are overregulating, bailing out troubled participants and intervening in every market. The Securities and Exchange Commission has accused others of trying to manipulate stocks, but the government itself is now the manipulator. The regulators should investigate themselves for bailing out Fannie Mae (FNM) and Freddie Mac (FRE), the creditors of Bear Stearns and the financial system with new lending facilities. They have swapped U.S. Treasury bonds for toxic securities. It is privatizing the gains and profits, and socializing the losses, as usual. This is socialism for Wall Street and the rich.

NYU Professor Nouriel Roubini talks to Barron's Robin Goldwyn Blumenthal about the state of the national financial situation, and the outlook for the future. (Part 1 of 2) (August 1)

So the government should have let Bear Stearns fail, not to mention Fannie and Freddie?

If you let Bear Stearns fail you can have a run on the entire banking system. But there are ways to manage Bear or Fannie and Freddie in a fairer way. If public money is to be put at stake, first all the shareholders of these companies have to be wiped out. Management has to be wiped out, and the creditors of Bear should have taken a hit. Why did the Fed buy $29 billion of the most toxic securities, and essentially bail out JPMorgan Chase (JPM), which bought Bear Stearns?

Because JPMorgan was a counter-party?

Exactly. The government bailed out everyone. Even the unsecured creditors of Fannie and Freddie should have taken a hit. Sometimes it is necessary to use public money to rescue institutions, but you do it in a way in which you're not bailing out those who made the mistakes. In each one of these episodes the government bailed out the shareholders, the bondholders and to some degree, management.

At what point does the government run out of money to lend to troubled banks?

Many public institutions are themselves going bankrupt. The FDIC (Federal Deposit Insurance Corporation) has only $53 billion of funds, and has already committed almost 15% of it to bail out depositors of IndyMac. The FDIC's deposit-insurance premiums weren't high enough, and now it is asking Congress to raise them. Plus, the agency claims only nine institutions are on its watch list. IndyMac wasn't on the watch list until June, the month before it collapsed. Studies done by experts in banking suggest that at least 8% of U.S. banks are in big trouble. Eight percent of the roughly 8,500 that the FDIC essentially is insuring equals about 700 banks. Another 8% to 16% also are shaky, so some 700 potentially are going bust and another 700 eventually could join them. Yet the FDIC is watching only nine institutions. It's a joke.

What recourse will the taxpayer have?

The taxpayer's bill is going to be huge. I estimate this financial crisis will lead to credit losses of at least $1 trillion and most likely closer to $2 trillion. When I made this analysis in February everybody thought I was a lunatic. But a few weeks later the International Monetary Fund came out with an estimate of $945 billion, Goldman Sachs (GS) estimated $1.1 trillion and UBS (UBS) $1 trillion. Hedge-fund manager John Paulson recently estimated the losses would be $1.3 trillion, and late last month Bridgewater Associates came up with an estimate of $1.6 trillion. So, at this point $1 trillion isn't a ceiling, it's a floor. And the banks, as I've said, have written down only about $300 billion of subprime debt.

How long will it take for the collapse in the banking sector to play out?

It is happening in real time. Many smaller banks are going bust already. More than 200 subprime-mortgage lenders have gone bust in the past year alone. And many community banks will go bankrupt. Community banks usually finance everything: the homes, the stores, the downtown, the commercial real estate, the shopping center. If you are in a town or a municipality where there is a housing bust, the bank is gone. Of three dozen or so medium-sized regional banks, a good third are in distress. That includes the Wachovias and Washington Mutuals of the world. Half of this group might go bankrupt. Even some of the majors could end up technically insolvent, though they might be deemed too big to fail.

NYU Professor Nouriel Roubini talks to Barron's Robin Goldwyn Blumenthal about the housing crisis, the "walkaway" phenomenon, and how it will play out. (Part 2 or 2) (August 3)

Take Citigroup. In 1991 there was a small real-estate bust, though the quarterly fall in home prices was only 4%, based on the S&P/Case-Shiller indices. Citi was effectively bankrupt and signed a memorandum of understanding with the Fed that allowed the government to give the bank regulatory forbearance. Citi was allowed to ride it out and try to recapitalize in a few years, and thereby avoid bankruptcy protection. This time around the S&P/Case-Shiller indices indicate home prices already have fallen 18%. The decline could be as much as 30%, because the excess supply is huge.

Nouriel, have you always been so negative about everything?

No. I'm actually a pretty mainstream economist. I was trained first in Italy and then in the U.S. and earned my Ph.D. at Harvard. My interests are in international market economics and international finance, and I'm not a 'perma-bear' on the stock market nor an eternal pessimist.

Leaving aside the fact that we are going to have a pretty nasty recession and international crisis, the global economy is going to grow at a sustained rate once this downturn is over. There are significant financial and economic problems in the U.S., and that's why I'm bearish about the U.S. But the emergence of China and India and other powers is going

to shift global economics and politics radically, and the world is going to be more balanced in the future, rather than relying on one engine, which has been the U.S. There are big issues ahead: How do you integrate the 2.2 billion Chinese and Indians into the global economy? There will be transitional costs and the displacement of workers, both blue-collar and white, in the advanced economies. But I'm quite bullish about the state of the global economy, and I'm positive about the medium and long term.

That's a relief. Thank you.