

Salon Speaker's Series
Grano Restaurant Toronto,
January 17, 2012

“Still plenty of clouds on the economic horizon”

Nouriel Roubini

NR: It's very hard to make forecasts on economic and financial affairs.

The famous Yankee coach Yogi Berra said, it's very hard to make forecasts, especially about the future. There is also the other joke about God having created economists to make weathermen and astronomers look very good in comparative terms. So with those important caveats about being modest about thinking about the future, I'll try to say something about this complex global economy.

I'd say it's a mixed bag. It's a glass vase half full and half empty.

There's certainly plenty of downside and things can go wrong, and I've been writing a lot about those things but there are also a lot of positive things in the global economy. So I think it would only be a fair

assessment to speak about the things that could go right in addition to the kind of things that can go wrong. I'll try to be balanced.

Certainly, the last year has been difficult for the global economy and for financial markets. If you think about what happened in 2011 -- before we talk about what may be happening next -- there was a whole series of surprises. There were sources of uncertainty and unexpected events that actually shocked both the economies and the financial markets. Last year started with a very sharp rise in commodity prices which might have been good news for countries like Canada that are commodity exporters, but there was the spectre of a rise in global inflation.

Then we had the Arab Spring, with turmoil and uprisings starting in Tunisia, then Egypt, Libya and so on and that led to a spike in the price of oil, leading towards perhaps global stagflation, maybe recession and rising inflation because of the geopolitical risk coming from the Middle East. Then you had this terrible and tragic earthquake in Japan. In addition to the massive loss of life and the destruction of property, there was a massive destruction of global supply chains that led to a slowdown of production activity in Asia, and even in the United States and in Europe.

Then you had the turmoil in the Eurozone. The problems of the Eurozone spread, starting in Greece, then Ireland, then Portugal and then to other parts of the Eurozone, as well. And then in the United States we had this ongoing saga about the U.S. fiscal deficit. We almost shut down the government three times last year, in this debate between Democrats and Republicans over whether to cut spending or raise taxes. We almost had even a technical default on U.S. treasuries because of the debate on the debt ceiling.

Now, the more optimistic people said, some of these shocks were random shocks; they were unexpected, terrible events. Who could have expected such an earthquake in Japan? Who could have expected the turmoil in the Middle East? But the reality is that unfortunately we still live in a world in which there are always tail risks. There are sources of uncertainty and risk that are macroeconomic; there are sources of risk that are fiscal, financial, regulatory, geopolitical, related to taxation, related to policy. So many of these shocks are not just random shocks that are temporary; they are persistent.

For example, take what's going on right now in the Middle East. The trouble started in Tunisia, then Egypt, then Libya, now we have

turmoil in Syria, in Yemen. People in the Middle East tell me, watch what's going to happen in Jordan, in Bahrain, in Kuwait, in the eastern provinces of Saudi Arabia. Now there are rising tensions between Turkey and Iran, between Turkey and Cyprus, between Turkey and Israel, between Israel and the Palestinians, between Israel and the United States and Iran. There may even be a military confrontation between the U.S. and/or Israel and Iran on the issue of nuclear proliferation. The U.S. has left Iraq but now the turmoil and ethnic conflicts within Iraq are becoming sources of tension. The Middle East alone can be a source of tail risk for the global economy, spiking oil prices and leading again to shocks that are stagflationary in the global economy.

That's only one of the geopolitical risks. Let's think about what could happen in North Korea or in Kashmir or in Afghanistan or in other parts of the world. Those are recurring shocks that we have to think about.

Or think about the problems of the Eurozone. It started in Greece, then it moved to Portugal, then to Ireland, then to Spain, then to Italy, to their banks, to their sovereigns. In the last few months the contagion has spread even to the core of the Eurozone: French banks,

Belgian banks. Last week, S & P downgraded from triple AAA both France and Austria. The turmoil has spread even partially to Germany so it is not even just a problem of the peripheral Eurozone. The core of the Eurozone is being affected.

Or take what's going on in the United States. You have massive gridlock in Congress, division between Democrats and Republicans. Democrats are against reform of entitlement spending, like Social Security and Medicare. Republicans are against any kind of tax increase. So one is vetoing tax increases and the other one is vetoing spending cuts. We're kicking the can down the road. This is going to be an election year, so of course we're not going to make any progress on the structural budget deficit from tax reform, on the fundamental issues of the United States. Therefore this saga of uncertainty from what's going to happen in fiscal policy is not going to be resolved.

It might not even be resolved after the election. We don't know whether Obama is going to be re-elected, whether it's going to be a Republican, whether it's going to be Romney or another one. But guess what? If Obama is re-elected, he might have the White House but he's not going to have sixty votes in the Senate and therefore Republicans can essentially veto lots of things they don't like. Suppose

that Romney is elected. He will have the White House, he might even have the House, he might have a majority in the Senate; but most likely he's not going to have sixty votes in the Senate, so Democrats can stall on entitlement reform.

People say, the gridlock is going to be resolved in the United States next year, whether Obama or a Republican is elected. But the gridlock could be the same as before with reciprocal vetoes and things may not change.

The point I want to make to start is that unfortunately we live in a world with all these sources of uncertainty. Last year these sources of uncertainty implied that financial markets and asset prices were like a yo-yo -- zig-zagging up and down. Risk was on when good news came out, risk was off when risk aversion was high and there were tail risks. U.S. equities were flat for the year. European equities and emerging markets were down for the year. This year is going to be another year where many of these different tail risks are going to be affecting markets. So there will be some positives that I will discuss, that could lead to an improvement of the economies and financial markets, but there are plenty of downside risks that are going to stay with us. That is the kind of background we have.

Now, what is the good news? What are the things that can go right in the global economy? Not everything is wrong, in spite of the fact that, as I said, the news for the last year was all about these negative events and tail risks. Several things are good about the global economy. The first one, of course, is that we have global economic recovery, after the most severe financial and economic crisis in the last sixty years. It's been bumpy, it's been fragile, but there is recovery in emerging markets and in most advanced economies.

Secondly – and I think this is more of a secular thing, not cyclical – is the rise of the financial and economic trading power of emerging markets. A larger share of GDP and global growth for the next decade is going to be driven by the growth of emerging market economies. That's good news because it means you'll have many different engines, locomotives of global growth, not just the U.S., Europe and Japan, the traditional ones. The best positive story about emerging markets is not about China, India or emerging Asia. Actually, lots of good things are happening in parts of Latin America, in parts of Central Europe, in parts of Central Asia, even in the Middle East.

The headlines about the Middle East have been about the turmoil, but let's not forget that there is a huge amount of oil and energy wealth in the Gulf which can be used productively for increasing growth. Even in sub-Saharan Africa, which for decades was stuck in under-development and poverty and civil war and disease, many things are changing; from East Africa, Kenya, Tanzania, Uganda, Rwanda, in West Africa, Ghana, Nigeria, in Southern Africa, South Africa, Mozambique, Angola, Botswana. So lots of good things are happening.

The rise of economic power of the emerging markets is going to be something positive for global economic growth, and certainly it's going to be a source of demand for natural resources. The reason Canada, Norway, Australia and other advanced economies are doing well is their resource orientation, given the huge appetite for resources, not just from China but from fast-growing emerging markets. So that's another positive.

A third positive of the global economy is that if you are looking at the balance sheets of many sectors of the economy, there's one sector that has a strong balance sheet: the high grade corporate sector, meaning corporations in the U.S., in Canada, in Europe, in Japan, in Australia, in advanced economies and emerging markets. These

corporations now are efficient, are productive, they've reduced structure, they've reduced cost, they've become highly profitable, earnings have been surprising and on the upside quarter after quarter. And if they become more confident about their recovery they're sitting on trillions of dollars of cash they can put to work; more spending, more hiring, more activities. Other sectors are weak and fragile and have to de-leverage, but the corporate sector is strong. That's positive.

A fourth factor that is positive about the global economy is globalization. International trade, in spite of the backlash against it, is still ongoing. There is more trade in goods, there is more trade in services -- because many services are becoming trade-able -- more movements of capital, more migration of labour, more international trade in news information, technology, you name it. That's a positive.

The fifth positive factor about the global economy: in the long-run, productivity change and economic growth depend on technological change and innovation, and there are so many sectors -- new or traditional -- that can be a source of a great innovation. Some of the new sectors are what people refer to as ET, or energy technologies. Within energy technology we have things that have to do with fossil

fuels, as well as new stuff like oil sands in Canada, shale gas in the United States. We have alternative energy and renewable resources. Many innovations and developments are probably going to be in the field of BT, or bio-tech. Great stuff is happening in biomedical research, stem cell research and gene therapy. That's exciting. And maybe there is going to be lots of innovation in IT, information technology. Web 2.0, 3.0, social media, cloud computing, artificial intelligence, new telecom, integration of traditional new media.

So whether it's ET or BT or IT, lots of great stuff is happening and this technological innovation is occurring not just in advanced economies but also in emerging markets. From solar technology to electric batteries for cars, stuff is happening in India and in China.

Those are the positives, and we should recognize them. In some sense, those positives are going to be dominating in the long run. Because if you can overcome the short-term actual difficulties – and the problems we are facing with the Eurozone, with the U.S., and with the Middle East have to do with the short term -- the future in the long run can be much brighter. John Maynard Keynes once famously said, when he was asked about the long run, in the long run it doesn't matter because in the long run we're dead.

In some sense, I think it's the reverse: if you can survive the short run, the long run can be very bright given all these technologies and innovations. The problem is you could be dead in the short run, not in the long run, because unless we resolve these financial difficulties from Europe and around the world, another global financial crisis could kill all of us – metaphorically, of course. Therefore, the challenges are to survive through the short term to make sure that all the long-run sources of economic growth are going to make us wealthier. So, in some sense, the pressing challenges are more in the short term.

What are the short-term challenges? Many of them are familiar. Unfortunately, economic recovery in most advanced economies has been anaemic, sub-par, below trend, more like a U-shaped recovery rather than the typical V-shaped recovery you get after a typical recession. The reason it has been anaemic, sub-par, below trend, is that this is not the typical recession. It was a recession caused by a financial crisis and the financial crisis was caused by too much debt and leverage, first in the private sector -- houses, banks, financial institutions, even the fat tail of some parts of the highly leveraged corporate sector -- and now as a response to the crisis, we've had a massive increase in public debt and leverage.

We are now left with the usual amount of private debt and also a large increase in public debt. Unfortunately, history suggests that whenever you have a balance sheet crisis derived by too much debt and leverage, the recovery for up to a decade can be anaemic. Why?

There's a very painful process of de-leveraging. You have to spend less, in the private and public sector, in order to reduce your debt and leverage over time, and that means that economic growth is going to be anaemic. Whether you are looking at the United States or the Eurozone or the U.K. or Japan, the recovery in most advanced economies has been anaemic.

Now, there are some exceptions. The exceptions are those countries like Canada, like Australia, like Norway, that have the commodity orientation and got lucky. Other exceptions are emerging markets that were growing very fast and were having good supervision and regulations of their financial systems.

But even a Canada, a country that has much better macro-financial fundamentals than most, is affected. It cannot fully de-couple from economic weakness in Europe or the United States. This year, unfortunately, even in Canada economic growth is going to be below

potential because of the headwinds coming from the United States and from the Eurozone. No country is an island. Trade links, financial links, currency links, commodity links and equity market links imply that when there is economic slow-down in the Eurozone and in the United States it affects even countries with sounder fundamentals. That is the reality of living in a world that is interdependent and globalized.

De-leveraging is going to be a painful process. It's going to take many more years and it implies economic growth is going to be low and unemployment rates are going to remain high in many advanced economies; with all the consequences of having so many people out of jobs.

A second risk to the global economy is the Eurozone. If there is something that could have systemic effects and trigger another global financial crisis and another recession at a global level, it is the problems of the periphery of the Eurozone. As I said, the contagion has spread from the periphery to the core. And unfortunately, the approach of the Eurozone has been not realizing the severity of the crisis. There is an economic crisis, there is a banking crisis, there is a sovereign debt crisis, there is a long-term competitiveness crisis, there is a fiscal crisis and they're all tied together.

Unfortunately, the approach of the Europeans has been to muddle through until now; kick the can down the road; extend and pretend; pray and delay; pretend that every problem is a problem of liquidity rather than a problem of solvency. When the private sector got in trouble we had the public sector bail out the private sector. Then, when somebody's government got in trouble we pretended they were not liquid, rather than insolvent, and we had super-national authorities bail out the national authorities – the IMF, the FSF, the ECB.

So we went from private debt to national debt, and then on to super-national debt. But we cannot keep kicking the can down the road, because nobody's going to come from the moon or Mars to bail out the IMF or the FSF or the ECB. Therefore, if the problems are structural you have to address them. There are two choices for Europe: either they move forward gradually in the direction of greater economic, fiscal, financial and political integration and union; or they are going to go in the direction of a gradual disintegration where there'll be serial debt restructuring in the private and public sectors, eventually serial defaults and even that is not going to be enough to restore the competitiveness.

The periphery, gradually one or more countries, could exit the Eurozone. Now, if a small country like Greece was to exit the Eurozone and Italy and Spain are successful to some degree in recovery, then the Eurozone survives. But if Italy or Spain, the third and the fourth largest economies in the Eurozone, were to exit the union that would effectively be the break-up of the Eurozone. A disorderly outcome in the Eurozone – either disorderly defaults or disorderly exits – could be a shock that is much more severe than the disorderly collapse of Lehman in the fall of 2008 that led to the global financial crisis.

If you think about it, Greece was a three hundred billion Euro public debt problem and Lehman was a six hundred billion dollar private debt problem. Italy and Spain alone are three trillion Euros public debt, or four trillion U.S. dollars. So a disorderly default by either one will have systemic consequences, let alone a disorderly exit. Those are the challenges that the Eurozone is facing. Some people are more optimistic, some people are more pessimistic. We live in uncertainty. We don't know how many of these countries are insolvent, how many of these countries are going to necessarily exit the Eurozone. Definitely, of all the risks that the global economy is facing, those coming from Europe are the most severe.

What about the United States? United States data for the last two or three months have been slightly better than expected. The worst of the outright double dip recession in the U.S. is over, but in my view U.S. economic growth this year is going to actually surprise on the downside. I don't think that this economic strength is going to remain. It's not going to remain with us for a number of reasons.

First of all, the de-leveraging in the U.S. has barely started. And that de-leveraging is going to imply slow economic growth. Secondly, the labour market is improving but not very much. The unemployment rate is still above 8 % -- or 15 % if you include discouraged workers and partially employed workers. Half of those unemployed are now structurally long-term unemployed so there is true long-term unemployment in the United States. Consumers are income challenged, because real wages are not growing very much, and they're wealth challenged because of their financial situation. Home prices are still falling and equity market wealth has been flat for the last year, so that's a negative. Therefore, the economic and financial fundamentals of the U.S. consumer are kind of fragile.

Housing is still in a recession. Quantities are bottoming out but the supply is still above demand. Home prices are still falling. A million

more houses are going to end up in negative equity, with people walking away from their homes. The good news about the United States, as I said, is the high grade corporates that are sitting on two trillion dollars of cash. They could spend more and commit to more job hiring. The problem is that corporates in advanced economies, in spite of having great balance sheets, have been very cautious.

Why they have been very cautious? In my view, part of it is all these uncertainties and tail risks, right? If they don't know whether things are going to get better or worse, it's better to wait and see. You don't want to open the new factory, hire tons of new workers, if you don't know whether the Eurozone is going to blow up or not. That's a risk. So whenever that tail risk exists, there is an option of value waiting.

Secondly, firms are saying there is excess capacity. Why should I invest more? And the investment they do is usually to save labour. Or, if they have to invest, they're going to invest in fast-growing, emerging markets. Finally, firms are saying there is not enough final demand, so why should I hire more or invest more? But that's a bit of a catch-22. If you're saying I'm not going to hire because there is not enough final demand, if you don't hire enough there is not enough labour income growth, there is not enough job growth, there is not

enough consumer confidence, there is not enough consumption, there is not enough final demand. It becomes a vicious circle. That's part of the problem. Given uncertainty, everybody is on hold.

A final observation about the U.S. is that if domestic demand is going to remain weak because there is de-leveraging of the private and public sector, the only way the U.S. could grow faster is if the trade balance of the U.S. or foreign demand were to strengthen. And unfortunately, U.S. trade balance is not going to improve very much this year for at least three reasons. First of all, the dollar is not weakening, it's strengthening. Whenever there is a tail risk people dump the Euro. Emerging markets, rightly or wrongly, go to the safety of the U.S. dollar and the stronger dollar means a weaker trade balance.

Secondly, because there is a slow down of growth in Europe in emerging markets, you're going to have a slow down of growth in the United States. Three, because of the geopolitical risk in the Middle East oil prices are still very high and therefore the energy import bill for the U.S. is going to remain high and the trade balance is not going to improve.

The U.S. in relative terms -- compared to the Eurozone which is falling into a deeper recession -- is doing well. I'm not in the camp of those who say there is going to be very strong economic growth in the U.S. In some sense, the U.S. as much as Europe has been kicking the can down the road, not addressing the long-term competitiveness issue, the gridlock in Congress, the division between the two parties, and at some point the markets are going to revolt.

The final remark I'll make is about emerging markets. As I said, they've been the bright shining star in the global economy, with strong economic growth, more like a V-shaped recovery. But China, especially, is a country that is subject to downside risks. I think that China this year is not going to have a hard landing because they're going to have a delicate political transition.

They have to change their new premier and president at the end of this year and they will do anything necessary to maintain their economic growth above 8 %. That is what they need to maintain social and political stability. However, the growth model of China, as their premier has said, is unbalanced and unsustainable. It's based on fixed investment that is 50 % of GDP, on high savings and on consumption being very low. Consumption in China is only 33 % of GDP. In the U.S.

it's 70%. In the U.S. we consume too much. In China, it's just the opposite – not enough consumption and too much saving.

No country in the world can be so productive that they take every year half of their GDP and invest it into new capital stock. Fixed investment in China is now 50 % of GDP, and you're looking at, down the line, three problems: one, a massive increase in the non-performing loans of the banking system, because many of their promises are going sour; secondly, China is going to have a public debt problem. Our estimates say that today in China the public debt is already 80 % of GDP. The official number is 17 for the central government but you have provincial governments, the policy development bank, the stabilization bonds, the railway ministry debt, so you end up with 80 % of GDP. It looks like the U.S. or Europe; and three, every episode of an over-investment boom with too much fixed capital accumulation has ended up in a hard landing. There is no historical example of a country which achieves a soft landing from over-investment.

And when I say over-investment I don't mean just in real estate.

Every investment boom in housing or real estate ends up in the bust.

Look at what happened in the last few years in the U.S., in the U.K., in Iceland, in Ireland, in Spain, in Dubai. It's happening now also in Hong

Kong and Australia, even in Canada. And it's happening in China. But even over-investment in industrial capacity usually ends up in a hard landing. Look at what happened to the Soviet Union in the 1970s and 1980s, to Latin America between 1970 and 1980, to Japan with the investment boom of the 1980s leading to the bust of the 1990s, the U.S. tech boom and bust.

The closer example to China was East Asia. By 1997, East Asia's fixed investments capital spending was 30 to 35 % of GDP -- in Korea, in Malaysia, in Indonesia, in Thailand, and you know the story of the East Asian bust and financial crisis. In China today it's 50 % of GDP.

Therefore, eventually, that investment bust is going to occur. Unless China finds a way to save less and consume more, they're going to have that slow-down of housing, of infrastructure, of industrial capacity. And if you're going to have a hard landing in China, the second largest economy in the world, the consequences for China, for Asia and for commodity exporters in advanced economies and emerging markets will be very severe and significant.

Now, I don't predict that that hard landing is here. I think it's a story for 2012, 13, or 14. China -- if it accelerates certain reforms to reduce savings and increase consumption -- could avoid that hard landing, but

that's a risk we're facing right now. So whether you look at the Eurozone, the United States or even China, there are these downside risks to the global economy.

As I said at the beginning, at the end of the day it's a mixed bag. There are some positives and we should recognize them. Emerging markets are a positive, commodities are a positive, the balance sheets of high grade corporates are a positive, globalization, trade, technological innovations -- all those things are positives. But there are risks. There are geopolitical risks throughout the world -- there are economic risks, there are fiscal risks, there are Eurozone risks, there are risks from the United States, there are also risks from China and emerging markets.

When there is positive news, risk is going to be on. When there is negative news, risk is going to be off. I think that anybody, whether you are an individual or an investor or firm, has to realize that you're going to be living in a world in which there is risk, there is uncertainty, there are surprises and you have to manage them in your investment decisions, because while we would like to be in a world where there is less volatility, volatility is here to stay.

You know, the Chinese say, may you live in interesting times, but that is actually a curse in Chinese. The times have become a little too interesting and too volatile. We wish they were less volatile and still very interesting but we live in a world in which there are so many sources of uncertainty, and that is the world in which we have to live, to learn, to do business and to succeed. So that is a little bit of a summary of the way in which I see the world and I'd be happy to answer any questions you have. Thank you very much.