The *Radical* Approach

BY NOURIEL ROUBINI

Why we're not yet out of the woods.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

The rich world's financial system is headed towards meltdown. Stock markets have been falling most days, money markets and credit markets have shut down as their interest-rate spreads skyrocket, and it is still too early to tell whether the raft of measures adopted by the United States and Europe will stem the bleeding on a sustained basis.

A generalized run on the banking system has been a source of fear for the first time in seven decades, while the shadow banking system—broker-dealers, non-bank mortgage lenders, structured investment vehicles and conduits, hedge funds, money market funds, and private equity firms—are at risk of a run on their short-term liabilities.

On the real economic side, all the advanced economies—representing 55 percent of global GDP—entered a recession even before the massive financial shocks that started in late summer. So we now have recession, a severe financial crisis, and a severe banking crisis in the advanced economies.

Emerging markets were initially tied to this distress only when foreign investors began pulling out their money. Then panic spread to credit markets, money markets, and currency markets, highlighting the vulnerabilities of many developing countries' financial systems and corporate sectors, which had experienced credit booms and had borrowed short and in foreign currencies. Countries with large current-account deficits and/or large fiscal deficits and with large short-term foreign currency liabilities have been the most fragile. But even the better-performing ones—like Brazil, Russia, India, and China—are now at risk of a hard landing. Many emerging markets are now at risk of a severe financial crisis.

The crisis was caused by the largest leveraged asset bubble and credit bubble in history. Leveraging and bubbles were not limited to America's housing market, but also characterized housing markets in other countries.

Nouriel Roubini is Professor of Economics at the Stern School of Business, New York University, and Chairman of RGE Monitor.

Moreover, beyond the housing market, excessive borrowing by financial institutions and some segments of the corporate and public sectors occurred in many economies. As a result, a housing bubble, a mortgage bubble, an equity bubble, a bond bubble, a credit bubble, a commodity bubble, a private equity bubble, and a hedge funds bubble are all now bursting simultaneously.

The delusion that economic contraction in the United States and other advanced economies would be short and shallow—a V-shaped six-month recession—has been replaced by certainty that this will be a long and protracted U-shaped recession, possibly lasting at least two years in the United States and close to two years in most of the rest of the world. And, given the rising risk of a global systemic financial meltdown, the prospect of a decade-long L-shaped recession—like the one experienced by Japan after the collapse of its real estate and equity bubble—cannot be ruled out.

A housing bubble, a mortgage bubble, an equity bubble, a bond bubble, a credit bubble, a commodity bubble, a private equity bubble, and a hedge funds bubble are all now bursting simultaneously.

Indeed, the growing disconnect between increasingly aggressive policy actions and strains in the financial market is scary. When Bear Stearns' creditors were bailed out to the tune of $30 billion in March, the rally in equity, money, and credit markets lasted eight weeks. When the U.S. Treasury announced a bailout of mortgage giants Fannie Mae and Freddie Mac in July, the rally lasted just four weeks. When the $200 billion rescue of these firms was undertaken and their $6 trillion in liabilities taken over by the U.S. government, the rally lasted one day.

Until the recent U.S. and European measures were announced, there were no rallies at all. When AIG was bailed out to the tune of $85 billion, the market fell 5 percent. Then, when the $700 billion U.S. rescue package was approved, markets fell another 7 percent in two days. As authorities in the United States and abroad took ever more radical policy steps from October 6–October 9, stock, credit, and money markets fell further, day after day.

Do the recent measures go far enough? When policy actions don't provide real relief to market participants, you know that you are one step away from a systemic collapse of the financial and corporate sectors. A vicious circle of deleveraging, plummeting asset prices, and margin calls is underway.

So we cannot rule out a systemic failure and global depression. As we have seen in recent days, it will take a big change in economic policy and very radical, coordinated action among all advanced and emerging-market economies to avoid disaster. This includes:

- Another rapid round of interest-rate cuts of at least 150 basis points on average globally;
- A temporary blanket guarantee of all deposits while insolvent financial institutions that must be shut down are distinguished from distressed but solvent institutions that must be partially nationalized and given injections of public capital;
- A rapid reduction of insolvent households' debt burdens, preceded by a temporary freeze on all foreclosures;
- Massive and unlimited provision of liquidity to solvent financial institutions;
- Public provision of credit to the solvent parts of the corporate sector in order to avoid a short-term debt refinancing crisis for solvent but illiquid corporations and small businesses;
- A massive direct government fiscal stimulus that includes public works, infrastructure spending, unemployment benefits, tax rebates to lower-income households, and provision of grants to cash-strapped local governments; and
- An agreement between creditor countries running current-account surpluses and debtor countries running current-account deficits to maintain an orderly financing of deficits and a recycling of creditors' surpluses to avoid disorderly adjustment of such imbalances.

Anything short of these radical and coordinated actions may lead to a market crash, a global financial meltdown, and worldwide depression. The measures adopted by the United States and Europe are a start. Now they must finish the job. ◆