PEOPLE IN ECONOMICS

Seeing Crises Clearly

Prakash Loungani profiles economist

Nouriel Roubini

THE "Power 50"—that was what *Institutional Investor* called its 2009 list of the 50 most influential people in the financial world. Many of the names were those of top policymakers and CEOs such as Ben Bernanke and Warren Buffett. Only one professor of economics made the list: at number 44, one notch below Saudi investor Prince Alwaleed bin Talal, was Nouriel Roubini of New York University.

It is a satisfying turn of events for Roubini, who was drawn to economics for its potential to influence public opinion and policies. Two decades ago, Roubini was known primarily in academic circles for influential work on how political conditions affected economic outcomes. A decade ago, he was starting to make his name outside academia as a provider of information and analysis on the Asian financial crisis. Today, he is becoming a household name, lauded in the words of *Institutional Investor* for "predicting that a U.S. real estate crash would cause banking failures and a deep recession."

He travels extensively these days to lecture about the effects of the crash he predicted. Ticking off a recent two-week itinerary—"Istanbul, Dubai, Abu Dhabi, London, Moscow"—he pauses: "I'm forgetting some place in between. What is it? Oh yes, Davos!"

Italian influence

Roubini calls himself a "global nomad." Of Iranian descent, and born in Istanbul, he grew up in Israel and Italy, receiving his bachelor's education at Bocconi University in Milan in the late 1970s. "There was a lot of social and political turmoil in Italy at this time. And many people like me, even in their teens, were socially conscious and cared about this.... Economics offered a way to understand the world and then, hopefully, through good policies, also change it for the better."

He had a role model in Mario Monti, an economics professor at Bocconi, who went on to become very influential in European policymaking circles (see *F&D*, June 2005, for a profile of Monti). The Yale-trained Monti was "a charismatic leader and teacher," says Roubini. "He was a serious academic but he cared about policy."

When it came time to pick graduate schools, Roubini faced the Cambridge vs. Cambridge choice that confronted many promising students. There was a tradition of Italian students going to the University of Cambridge in the United Kingdom, attracted by the presence there of the noted Italian economist Piero Sraffa. But by the 1980s, students were more likely to turn to Cambridge, Massachusetts, where another great Italian economist, Franco Modigliani, was ensconced at the Massachusetts Institute of Technology (MIT).

Roubini picked Cambridge, Mass., but went to Harvard rather than MIT. Why? "I didn't get into MIT," he says. "But please make it clear that I take no offense. These things happen." In fact, he got the benefits of interactions with both Harvard's superstars—"Jeff Sachs, Larry Summers, Robert Barro, and Greg Mankiw were around"—and MIT's. "I would attend classes [at MIT] by Rudi Dornbusch, Stan Fischer, and Olivier Blanchard," he says. His first job after graduating from Harvard in 1988 was at Yale.

Fiscal follies

Influenced by the saga of Italy's struggle with large and persistent budget deficits, Roubini was drawn to the study of fiscal policy—how governments decide how much to spend and how to pay for it. It was a time when governments were spending and not paying for it, at least not right away.

"It was quite striking," says Roubini. "In the 1970s and early 1980s, many countries in Europe had deficits of about 4 percent of GDP, and in some, such as Belgium, Greece, and Italy, deficits were as high as 10 percent of GDP." As a consequence, government debt increased significantly: the debt of the countries that would later make up the euro area "nearly doubled, from something like 30 percent to 60 percent" of their combined incomes. The United States and Japan also ran persistent deficits.

Two views prevailed in the academic arena of what gave rise to these government deficits and how much to worry about them. One view, put forward by Nobel Prize winner James Buchanan, was that there was a chronic tendency toward budget deficits because warring politicians competed for the votes of special interest groups by promising them a continuous IV drip of government spending.

The other view, whose main proponent was Robert Barro, was that on deficit spending governments tended to do the right thing over the long run: they ran up deficits in times of need, such as during wars and recessions, and paid back the debt—albeit fairly slowly—in tranquil times. This view was supported by the behavior of the U.S. and U.K. governments, which had behaved in roughly this fashion over the long sweep of history.

Roubini's contribution, in work done in the mid-1980s with Alberto Alesina and Jeffrey Sachs, was to carve a middle passage between these two views. He looked carefully at the political situation in countries to understand when it was more likely that governments would be captured by special interests, but did not downplay the economic factors that also contributed to deficits.

In a series of papers, Roubini demonstrated that when power is dispersed, say across many political partners in a coalition government, there was a greater tendency toward out-of-control budget deficits; the shorter the expected tenure of the coalition government, the greater this tendency. Adverse economic conditions raised the odds that fights would break out among coalition partners, further exacerbating the loss of fiscal control.

This marriage of politics and economics made it possible to explain better the behavior of government deficits across the range of industrial democracies. It explained why Italy, which had decades of short-lived coalition governments, found it difficult to control budget deficits. But it also explained why Japan was able to sustain its plan to reduce budget deficits in the 1980s—the unbroken majority control of the ruling party there, and its expected longevity in office, gave it the political space to pursue such a policy.

Fiscal bondage

Japan was an early mover in a trend toward fiscal correction that was to characterize industrialized economies in the mid-1980s. Roubini thinks it may have been a reaction by voters to the enormous expansion of the public sector during the 1970s. "Around 1985," he points out, "every G-7 government was headed by a right-of-center party," and fiscal restraint was in the air. The prevalent feeling was that fiscal rules—explicit benchmarks—were needed to check governments' tendencies toward unrestrained deficits.

The most noted examples of such rules were those in the 1992 Treaty of Maastricht, which set preconditions on countries wishing to join the European Monetary Union. In the area of fiscal policy, these so-called Maastricht criteria were that budget deficits should not exceed 3 percent of GDP and government debt should not exceed 60 percent of GDP.

In a now famous 1993 paper, "Excessive Deficits: Sense and Nonsense about the Maastricht Treaty" (written with Yale colleague Willem Buiter and then-student Giancarlo Corsetti), Roubini criticized these criteria as a case of "serious fiscal overkill." The problem with the Maastricht criteria was that they did not make any allowance for the state of the economy. Even in the face of a recession, governments were expected to keep to their plan for reducing deficits and debt until the criteria had been met.

Nor did the criteria recognize that some government spending took the form of investments, say in infrastructure, that could generate revenues in the future. The implementation of the criteria "would require an excessive degree of fiscal retrenchment which would adversely affect the level of economic activity," Roubini and his coauthors concluded. They recommended that the "criteria should be disregarded or applied quite loosely."

In any event, some European countries found it difficult to meet the stated criteria but were waved into the union nevertheless. And in 2005, the rules themselves were relaxed, providing more explicit scope for countries to let deficits increase in the face of adverse economic conditions. Roubini supports these changes and feels vindicated: "I think that the amendments go in the direction of what we had been suggesting from early on, in 1993. It took them a while, but what was eventually done was sensible."

Asian drama

With his work on political business cycles and on fiscal rules, Roubini was becoming quite well known in academic circles. But his name recognition went up measurably during the Asian crisis of 1997–99 as a result of an act of generosity uncommon among academics. He started to maintain a web page, which he made freely available to everyone, on which he posted and catalogued material about the crisis—reports by the IMF and other agencies, newspaper and magazine articles, private sector analysis, and technical papers by academics.

Soon, "Roubini's page" became the first port of call for those engaged in following or fighting the crisis. In January 1998, *The New York Times* acknowledged its influence, noting that "Professor Roubini maintains a site . . . that even people without an M.B.A. will find helpful in learning about the crisis. What the site lacks in fancy design it makes up in analysis, extensive links and a detailed chronology." Today, Roubini laughs that "the reporter was right about the design. In those days I was maintaining the page myself. It was just a wall of links, completely unsophisticated."

During the Asian crisis, Roubini was not just an aggregator of information but an active analyst. With his students Corsetti and Paolo Pesenti, Roubini offered the most comprehensive analysis of the Asian crisis. By academic standards, it was close to real time. In the November 1998 paper, Roubini and his coauthors wrote that at the root of the Asian crisis was "a long tradition of public guarantees to private projects. Even in the absence of explicit promises of bail-out . . . the corporate sector largely overlooked costs and riskiness of the underlying investment projects."

Roubini accused Asian governments of conducting policies that were "enmeshed within a widespread business sector network of personal and political favoritism" and interventions in favor of troubled firms. In such an environment, markets operated under the assumption that their return on investment was insured against adversity. Banks played along, "channeling funds toward projects that were marginal if not outright unprofitable from a social point of view."

This view of the crisis was controversial at the time because it appeared to blame the victim. But Roubini stands by his analysis. "I still see it as a moral hazard story," he says. Economist Paul Krugman "was right to say that this was a game of 'heads I win, tails the taxpayer loses.' It was because investors believed that the governments would protect them from most losses that you got the overinvestment, the excessive external borrowing, and the current account deficits."

Whistle-blowers

Roubini acknowledges there were others who sounded the alarm of a crisis before he did—and often just as loudly. "Raghu Rajan gave a very strong speech in 2005," he says, about excessive risk taking in financial markets and the possibility of a full-scale financial blowout. "He deserves a lot of credit for speaking out, particularly because he still had an official position" as the IMF's chief economist. Rajan returns the compliment, giving Roubini credit for acting on his convictions and noting that academics often labor under their own constraints: "Most academics . . . fear talking about things where everything is not neatly nailed in a model."

Another prominent whistle-blower was the Bank for International Settlements (BIS), which warned in its July 2007 annual report that the world economy was in danger of a major slump; *The Daily Telegraph* summarized the report with the headline "BIS warns of Great Depression dangers from credit spree." Roubini says that having his views shared in official circles such as the BIS helped him "stay the course." And, he says, he knew the "battle was won" when many Wall Street analysts and media commentators acknowledged that he had been right.

Abby Joseph Cohen of Goldman Sachs says that "Roubini was among the first to raise alarms" about financial fragility and that market participants no longer treat his views as "low-probability scenarios primarily of interest to academic economists." And Martin Wolf, the *Financial Times* columnist, wrote in a February 2008 column that "Professor Roubini's scenarios have been dire enough to make the flesh creep. But his thinking deserves to be taken seriously. He first predicted a recession in July 2006. At that time, his view was extremely controversial. It is so no longer."

Roubini and his coauthors offered nuanced policy advice on what was needed to overcome the crisis. Over the medium term, they argued, fiscal balances would have to improve to absorb the costs of bailing out the financial and corporate sectors. But because "in the short run the crisis led to a sharp fall in investment and output in the Asian region," the implementation of this adjustment ought to be postponed, "even at the cost of temporarily running large fiscal deficits." International rescue plans—such as those led by the IMF—can "play a crucial role," they wrote, "by helping to ease the crunch and avoid an even sharper decrease in investment and consumption."

"Over the past decade, his one-man Asian crisis web page has morphed into a 40-person operation called Roubini Global Economics Monitor, which aggregates and analyzes information on all international economics issues."

More so than many academics, Roubini has been a supporter of the IMF. He thinks this is partly because "he got to know the institution from the inside" at an early age. In 1985, while a second-year graduate student, he interned at the IMF. He has returned to the IMF many times in subsequent years and was an advisor to the U.S. Treasury from 1999 to 2001. During 2001–02 he worked with IMF staff on an approach to spotting vulnerabilities in financial and corporate sectors and wrote (with Brad Setser, now at the Council on Foreign Relations) a book that has become a standard reference on the appropriate policy responses to emerging market crises —entitled *Bailout or Bail-ins? Responding to Financial Crises in Emerging Economies*.

Emerging problems

Though his work on the Asian and other emerging market crises had made him well known in policymaking circles and among some segments of the media, Roubini's ascent to fame truly began when he started to sound alarms of a crisis much closer to home. Starting in 2005, and increasingly in 2006, Roubini says the runup in asset prices, the relaxed lending practices of the financial and corporate sectors, and the large current account deficits had him thinking: "Hey, wait a moment. The U.S. looks like an emerging market. Why hasn't it gone belly up?"

Roubini was one of a handful of observers who relayed their warnings to incredulous, often downright hostile, audiences (see box). In 2006, the global economy had just registered its fastest five-year period of growth in 30 years; the U.S. economy was doing well, having shrugged off the effects of the bursting of the dot-com bubble and the 9/11 terror attack. In September 2006, in a now-celebrated speech, Roubini told an audience of IMF staff that there was a more than 50 percent risk of a U.S. recession the following year. Over the past several years, U.S. consumers had gone on a spending binge, with many using their home equity as an "ATM." Now, he warned, "consumer burnout" is imminent.

Roubini drew a parallel between 2006 and 2001, when the U.S. economy had last slid into a recession: "What is happening today is that, instead of a glut of tech goods, we have a glut of housing stock and also a glut of consumer durables." The U.S. Federal Reserve Board could not stave off a recession, he said, "for the same reason that Fed easing did not work in 2001." If you have a glut, "you have to work it out, and interest rates effectively do not matter." Roubini also predicted that the rest of the world would not "decouple" from developments in the United States.

Charles Collyns, deputy director of the IMF's Research Department, says that by the time Roubini returned to speak at the IMF a year later he had been proved largely right. In fact, Collyns quipped in 2007, "perhaps Nouriel had not been pessimistic enough" in his year-earlier talk. Collyns also said that Roubini's views helped persuade the IMF early on to take a concerned view about global prospects.

Finding a balance

These days, Roubini leads a busy life, trying to be as he puts it "a full-time academic, a full-time policy wonk, and a full-time entrepreneur." He says that he has to find a better balance among these activities but doesn't know which one to scale back.

Over the past decade, his one-man Asian crisis web page has morphed into a 40-person operation called Roubini Global Economics Monitor, which aggregates and analyzes information on all international economics issues. Roubini says being an entrepreneur has given him insights into business that an academic professor of economics would never have. It's a sentiment with which his former colleague at Yale Robert Shiller agrees. A successful businessman as well, Shiller says that "for an academic economist, it is a good thing to run a business."

Perhaps he will be tempted into the Obama administration? Roubini says that's unlikely, adding that "in the last few years I have become used to being able to write freely and express my views without constraints. It would be a hard adjustment to go into a situation in which every word I say has to be cleared by somebody." Instead, he says, he is content with having an indirect influence on policy by expressing his views. "I don't want to overemphasize my influence, but I think that now when I write something, people read it and think about it. I'm happy with that." ■

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