Known in the economics profession as one of the most consistently bearish voices that correctly predicted the coming of the financial crisis that enveloped the world in 2008-09, Nouriel Roubini, professor of economics at New York University’s Stern School of Business – or, as he is more commonly known, ‘Doctor Doom’ – cuts a rather unimposing figure in real life.

He’s not at all like an end-of-world prophet.

“I prefer to be known as ‘Doctor Realist,’” he quipped. Roubini, who is also chairman of an economics research firm named after himself, Roubini Global Economics, was speaking at a talk organized by Singapore Management University’s Sim Kee Boon Institute for Financial Economics and the Economic Society of Singapore.

Good news
Among the encouraging signs he sees in the global macroeconomic recovery are the acceleration of growth in the US and the Eurozone, as well as decreasing risk of inflation as once-idle production capacity is consumed.

Most importantly, he sees a more multipolar world with more than one centre of economic gravity as demand shifts from the west to the east (think China, Asia) and from the north to the south (think emerging South America, sub-Saharan Africa).

Drilling down to corporate levels, balance sheets have been strengthening, with more cash generated and held in the last two quarters of 2010. Better-than-expected earnings have helped to push the global equity markets up by an average of 10 percent by end of last year.

“You can have a virtuous circle of a positive feedback loop as opposed to the vicious circle two years ago when prices and profits were falling,” said Roubini. He noted that there has been evidence of this new macroeconomic resilience, compared to the spring and summer of 2010.
Last year’s Greek debt crisis resulted in an almost 20 percent global equity market correction even though the small economy of Greece accounted for only 3 percent of the combined Eurozone GDP. By contrast, the recent rise in oil prices of almost 20 percent (since end 2010) as a result of the ongoing Middle East unrest has resulted in a 2-3 percent negative impact on the global equity market so far.

Low interest, high risk
What are the risks ahead? The primary issue, as identified by Roubini, is the structural and continuing levels of debt built up caused by a decade-long low interest regime. “The process of painful deleveraging in the private and public sector is still ongoing,” he said.

What this implies, is that the long term trend to spend less and save more will negatively impact future balance sheets and consumption. Together, these signal slower future economic growth: more likely a long U-shaped recovery than the sharper V-shaped one would have hoped for.

Meanwhile, the longer term sovereign debt crisis remains a concern. In many of the OECD countries, budget deficits have been hitting as high as 10 percent of GDP, and public debt has also been growing.

Ten to fifteen years ago, emerging markets were the ones with sovereign debt default issues; today the advanced economies are the ones that have failed to heed their own advice for these former basket-cases and are themselves at risk of sovereign debt default.

More worrying, a large proportion of these debts are contingent liabilities deriving from unfunded social security contributions. In other words, even governments do not now have clear ideas of the size of these debt obligations in the future. The only thing they know for sure is that they are unfunded and will get bigger.

For those countries facing ageing populations, these contingent liabilities look set to become a time bomb as public debt is rolled over to future governments. Those that will inherit the problem will not know what to do with it. For democratically elected governments, the political risk of declaring these liabilities void is a breakdown of authority or mass protests.

Kick first, pay later
Especially in the US, structural changes like private sector de-leveraging has been delayed, as households get tax transfers, reduction of payroll tax and so on. These are financed by further public sector borrowing, for example the so-called second round of quantitative easing. The debt problem is postponed, not tackled, making both the size and momentum of future de-leveraging more painful.

“The tax cut has been paid for with another trillion of public debt,” said Roubini. “Some of that strong growth of the previous quarters has been stolen from the future.” Such behaviour is akin to “kicking the can down the road and paying for it later” -- hoping that a future government will take care of it.
Worse still, if that postponed de-leveraging has to happen in the context of a future with less spending power, it will make the economic restructuring even more difficult to achieve. The context of a future with less spending power is especially pertinent given that the American housing bubble (that trip-wired the crisis of 2008-09) remains unresolved.

Much of the total US housing stock is still underwater in equity terms, with a consolidated unemployment of nearly 16 percent, said Roubini. If those homeowners fail to get good jobs that will at least pay their mortgage, more homes will be lost as owners simply walk out and default on their loans when finances are overstretched.

Because of persistently high unemployment rates, even policy-making that wriggles interest rates to control inflation will have only minimal impact. This is especially true where the timing and intended ‘bite’ of economic policies are vitally dependent on the presidential election cycle and their likely effects on the incumbent’s popularity.

In the shorter term, the multi-year near-zero interest rate environment, which has made the cost of borrowing so cosy, will have to change. “Even in the United States there will be the beginning of an exit from zero policy rates,” said Roubini. The target is short-run inflation, but this exit will nevertheless also have a dampening effect on a still-fragile recovery.

Inflating China
Further afield, inflation risks in China have worsened as more than two-thirds of the consumption basket is linked to basic food and transport, the prices of which are set outside China.

Stating the fundamental policy dilemma of the Chinese government, Roubini said: “China is not willing to use exchange rates as a way of controlling inflation” in an effort to protect its export competitiveness. This exposes the domestic economy to higher inflation risks and may further extend speculative bubbles in asset markets, especially real estate.

Meanwhile, other smaller emerging markets are shadowing China as they try to maintain their competitiveness vis-à-vis the renminbi. With near zero interest rates in America weighing down US rates, all these have become incentives to stoke asset bubble formation and growth in all these emerging markets.

Chinese GDP growth is still expected to hit about 10 percent this year, Roubini said, but he added that the prospect of a “soft landing” for the Chinese economy remains an open question.

Delink? Not quite yet
There is an increasingly popular view among some pundits that China, with its record of economic growth, will replace or supplant the US as a driver of world demand and hence growth. Some versions of that view are expressed in the so-called “delinking” thesis – that because global demand is now more evenly balanced, we will move away from over-dependence on American demand and so be less susceptible to cycles in economic performance there.

Not a chance, said Roubini.
The global economy going forward is one that will be more multipolar, but in the short run, there is little possibility of “delinking”, he said. For sure, there is the popular argument that China had displaced Japan as the world's second largest economy last year. But dig a little deeper: “About 300 million Americans consume US$10 trillion a year and 1.3 billion Chinese consumed only around US$1.5 trillion a year,” he noted.

Add another billion Indian consumers, many of whom are in the rising middle class, and we have an additional US$500 billion in consumption – not nearly enough to offset US demand. Simply put, the total consumption of 2.3 billion ‘Chindians’ (Chinese plus Indians) is only one fifth of the corresponding figure in America.

“China and India alone cannot be sustaining global economic growth,” said Roubini. In the medium term, China’s strategy to boost its GDP has been to rely on fixed investment (mostly foreign capital). Roubini reckons this could account for as much as half of Chinese GDP.

However, this could cause excess production capacity which will then create problems for the future as domestic consumption rises. There have been moves over the last few years to boost the proportion of domestic consumption as a self-sustaining component of Chinese GDP, but, as in many such planned moves, it will take many years before it becomes entrenched within the economy.

Additionally, the move to increase domestic consumption’s share as a proportion of GDP has its own set of dangers. China may find itself a price-taker in a rapidly expanding economy as inflation pressure invariably builds up.

Given the need to maintain the high growth rate needed to maintain social-economic stability – the topmost consideration of the Communist leadership – China's options to control prices without using market instruments (for example, interest and exchange rates), often will mean resorting to non-market means of controlling prices where and when the state deems it in its strategic interests to do so.

Based on these indicators, Roubini believes that the global macroeconomic cycle still has plenty of room to take everyone for an unexpected ride. Will there be a crash or a soft landing? Will America address its twin deficits and high employment quickly? Doctor Doom (or Doctor Realistic, take your pick) has his guesses, but as the saying goes; it never pays for a prophet to be too specific.

About the Author
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