Nouriel Roubini

The New York University professor, who has been gloomy on the U.S. economy for years, now expects a 'very severe recession.' By THOMAS R. KEENE, CFA

ECONOMIST NOURIEL ROUBINI predicted more than two years ago that the U.S. would fall into a recession because of the bursting of the housing bubble and rising energy prices. The reasons look prescient—even if the timing was off: He said growth would vanish by the end of 2006, and the economy kept expanding, at least through 2007.

Roubini, a professor at New York University's Stern School of Business, is sticking to his downbeat assessment. The U.S. economy is contracting now and will weather a "very severe recession" before it starts to improve, he says. Congress should help mortgage holders who can't make their payments, according to Roubini. The alternative is a wider bailout of failing financial institutions, he says. The following is an abridged version of a June 26 interview.

What are the prospects for the global economy, outside the U.S.?
There are significant signs of slowdown, if not contraction, in a number of other countries while inflation is rising throughout the world. Japan soon enough is going to be in a recession. A good third of Europe is going to be in a recession: U.K., Spain, Italy, Ireland, Portugal. Canada is in a recession. New Zealand is in a recession.

China and India and the other emerging markets cannot decouple from this U.S. and global economic slowdown. Right now, inflationary pressure because of the overheating of these [emerging economies] is still the most important factor. But they're now facing ... downside risk to economic growth [as well]. That's the worst of both worlds.

You have said mortgage holders need government help. Why is that your prescription?
We're on the verge of a systemic banking crisis. Let's be frank. The options are very simple. Either you nationalize the banks now or you nationalize the mortgages. When you have a systemic financial crisis, there is always a government bailout.

The Fed has taken on new duties to calm the markets. Is that a proper role?
Central banks were created not to smooth inflation and growth. They were created because there were bank runs. They were created to provide lender-of-last-resort support and, therefore, financial stability.

What we have discovered today is that even after we've provided the lender-of-last-resort support to banks, even after we have deposit insurance and avoid bank runs, there is a whole part of the financial system that's like banks, subject to bank runs. The Fed and every central bank has to worry about financial stability. There is no way back. That means also that we have to regulate nonbanks like banks.

Should the Fed and the government be bailing out nonbank firms?
Unfortunately, they have to be in the business of providing liquidity support to major, systemically important financial institutions. That was the lesson of Bear Stearns.

And once you've regulated and supervised banks and nonbanks like broker-dealers, there is no reason why you should not regulate also hedge funds or other highly leveraged financial institutions. These are all similar institutions.

Is part of the reason we're in this crisis that giant banks can't control risk?
Yes. The bigger they become, the issue of risk management becomes much more complex in these institutions. There are silos. And you don't get a holistic approach to risk management. We've spent the last 10 years speaking about self-regulation. That means no regulation. And about market discipline. There is no market discipline.