



## **A Leading Economist Mulls the Next Crisis**

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ECONOMIST JOSEPH STIGLITZ won a Nobel Prize in 2001 for his work showing that in any given transaction, the parties involved have unequal information, and as a result, markets aren't efficient.

These days, Stiglitz is more concerned with how inefficient markets impact society -- what he calls the "externalities." If, for example, a derivatives deal between two banks goes bad, the rest of us get hit as shock waves ripple through the economy. The credit crisis is one big externality and it's the theme the Columbia University professor explores in his new book, *Freefall: America, Free Markets, and the Sinking of the World Economy*.

Stiglitz thinks that a melt-down is around the corner in the debt-inflated commercial real-estate market. But he thinks the problems in Greece and other southern European nations are being overstated.

A former economic adviser in the Clinton White House, Stiglitz sat down with Barrons.com last week to explain the huge "externalities" spreading through the economy, plus a few thoughts about how investors should approach them.

Barrons.com: What are a couple scenarios for the U.S economy going forward?

Stiglitz: The current scenario is one where the economy is weak in terms of employment; foreclosures are continuing apace, and are expected to be higher this year than last; and bank failures are continuing and are also expected to be higher this year than last. Growth is not strong enough to create enough jobs for the new entrants to the labor force, and not enough to lead to a marked reduction in unemployment.

Q: What else do we have to worry about?

A: On top of that, there are a set of problems that are very likely to lead to a marked slowdown in the current growth trend toward the end of this year or the beginning of next. That includes almost a half a trillion dollars in rollovers of commercial real estate mortgages each year for the next three to five years, many involving loans that are under water and securitized. Second, the states and local governments are short by \$200 billion a year, and problems are mounting as they depend on property tax revenues and as the reserves that they have been living off get used up.. And with the Federal stimulus coming to an end in 2011, there will be a large "negative" stimulus from the states. Lastly, we have to manage the "exit" from the unusual monetary measures, with the Fed buying almost all home mortgages. Most economists say that if the Fed

stops buying, interest rates will rise, and that will make the home mortgage market, which is not in good health, even sicker.

Q: Might there be another stimulus package from the federal government?

A: I expect a small jobs bill, not enough to be the second stimulus that we need. In terms of the problems I described, deficit fetishism [the demand that the deficit be brought down] will undermine our ability to address these problems. There was a big risk when Obama came forward with an insufficient stimulus combined with a badly-designed bank bailout that the political will to make a second stimulus would be limited. That turns out to be the case.

Q: Are we cruising toward being Japan?

A: Yes, but I have to qualify that. Japan's labor force isn't growing because it doesn't have population growth. So for Japan, stagnation is zero growth [in the economy]. For the U.S., with the labor force growing at 1%, if the economy just grows at 1% [in real GDP terms], that's stagnation. The risk is that we will have growth but it will be sufficiently anemic so that per-capita income will not grow substantially. Somehow Japan managed through this period of malaise to maintain low unemployment by our standards. We're fighting that battle but right now, one out of six Americans who would like a full-time job can't get one, and that's a major contributor to social stress.

Q: How bad could the commercial real estate crisis get?

A: It could be very bad. If everything in the financial sector were hunky-dory, we might be able to get our way through this in the old fashioned banking way, by which I mean the banks would close their eyes and hold their noses as they rolled over mortgages that were underwater [where what is owed exceeds the value of the property]. We would pretend everything was fine, and the banks would pray that they were adequately re-capitalized before they had to roll them over again or before they went into default. The situation now is that the banks are not in great shape. They're already hiding through nontransparent accounting the residential mortgages. And the examiners, having been told they flubbed before, are doing their job, and that means they're saying if you're underwater, you can't just roll over.

On top of that, these loans have been securitized. Rolling over securitized loans is very difficult. A lot of the securitization was very complex, involving novel types of contracts. I've been told, though I can't verify it, that there's a lot of litigation risk ahead. They were afraid that one tranche might cause the whole thing to come down, so they had provisions in some of the contracts saying you couldn't bring the whole deal into default. And some courts have ruled that's not legal. You saw this in the deal over [New York housing unit] Stuyvesant Town, where there was an attempt to stave off bankruptcy, and it failed.

Q: So what will be done about all this?

A: It's not really clear what can be done. Look at residential mortgages: Many people said there were two things that should have been done, including bankruptcy reform, and provisions to

protect against litigation. Neither of those got through, because the banks didn't want restructuring, because they would have had to recognize losses, and litigation provisions didn't get through because of enormous conflicts of interest between service providers and first and second mortgage holders. Both problems will be prevalent in commercial-real estate, but perhaps on an even grander scale. Those who feel threatened by any litigation measures will oppose them.

Q: What kind of investment approach does that leave for people who play the markets? Do you have any money in the stock market at this point?

A: I keep most of my money out of the market. Investors will be focused on what kinds of goods are bought by upper-income people and by lower-income people. It was interesting to see Wal-Mart's (WMT) recent report, where sales were not doing as well as had been expected. That's disturbing. They had been doing relatively well as people down-scaled their expenditures.

Q: Do people move out of equities altogether, into say fixed income?

A: There are two conflicting perspectives on this: the dominant one is that the Fed is not likely to raise short-term interest rates for some time, which is what it's announced. In many ways, their analysis is consistent with mine. They don't see a quick recovery either. That obviously means that short-term Treasuries are not going to yield high returns. The fact that the national debt is increasing just in the inevitable fight against this recession and the balance sheet of the Fed is likely to go up because it won't leave quantitative easing quickly, will feed into longer-term inflationary anxieties. Some people are moving into gold, but the other financial product that protects one against inflation are TIPS. One might expect that TIPS will be a good investment.

Q: Everyone's worried about sovereign country defaults. Should they be?

A: My judgment on that is that it's totally unwarranted. Greece is able to make its debt payments, and they will in the end, if they need to be, be helped by the other countries of Europe.

Q: So Greece will not be allowed to fail?

A: That's right. You know, if there was commitments [by the rest of Europe] that were just a little stronger and clearer than the current commitments, Greece would have absolutely no trouble meeting their obligations, because interest rates would then be more reasonable. It would be a bailout that would cost Europe no money, unlike the bank bailouts here, where some banks were actually bankrupt. In my mind, those Greek bonds and similar sovereign debt are good buys, because you're getting a risk premium for no risk.

Q: Thanks for your time.