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The activist economist; Nobel-prize winning economist Joseph Stiglitz talks to VIKRAM KHANNA about post-crisis Asia, sovereign wealth funds and the US sub-prime debacle

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'IF ONE attains positions of power,' wrote Joseph Stiglitz, the 2001 Nobel Prize winner in economics, 'one should view them as opportunities for social change.' This was in his autobiographical essay submitted to the Nobel Prize committee. It is a dictum he has faithfully followed, never shying away from controversy - perhaps even relishing it - nor from social activism, and not afraid of taking flak.

As an undergraduate and student leader at Amherst College in the US in the 1960s, Dr Stiglitz waged a campaign to abolish student fraternities, because they were socially divisive. In the 1980s, he became involved in public interest litigation aimed at protecting the rights of native American-Indians. He also tried (unsuccessfully) to block sales of offshore oil tracts at what he called 'fire-sale prices' to private companies by the Reagan administration.

As chief economist at the World Bank during the late 1990s, Dr Stiglitz launched a withering critique of the IMF's handling of the Asian financial crisis of 1997/98 (to which the IMF responded in equally scathing fashion, accusing him of 'sniping at the paramedics while they were tending to the wounded'.)

More recently Dr Stiglitz turned his attention to championing various environmental causes. And as a vociferous opponent of the war in Iraq, he has come up with calculations to show that the actual cost of the war will be, not a couple of hundred billion, as officially claimed, but possibly as much as two trillion dollars; 'the official figures are only the tip of an enormous iceberg', he contends.

Apart from his predilection for plain speaking, one reason why Dr Stiglitz ruffles feathers is because, although he often sounds like a shoot-from-the-hip radical, he's anything but. He has taught at Princeton, Oxford, Stanford and Yale universities, in addition to Columbia, where he is now. He has chaired former President Bill Clinton's Council of Economic Advisers, written a dozen books, authored hundreds of articles in both academic journals and the popular media and been awarded 27 honorary doctoral degrees. In other words, when he speaks out, people are forced to take notice, because of not only what he says, but also who he is.

During our conversation, in-between sessions at the Singapore Economic Review conference in early August, Dr Stiglitz reflects on Asia's economic recovery. 'It's remarkable how well Asia has done over the last decade,' he says. 'Many people were worried that the impact of the Asian crisis would be long-lived.'

And here, he sticks it to the IMF again. 'The fact that Asia's economies recovered so quickly shows that the IMF diagnosis was totally wrong. Because if the problems were deep-seated structural problems as the IMF alleged, those can't be corrected in six months. You can't change societies in six months. All the problems the IMF identified - poor corporate governance, the lack of transparency, etc - they may have been problems, but they didn't give rise to the crisis.'

Rethink of strategies

After the crisis, Asian countries faced two key issues, he says. One was to rethink development strategies. 'The growth of China made manufacturing much more competitive. But at the same time, there were new niches opening up. It was both an opportunity and a challenge.'

Some countries dealt with it well. 'For instance, Korea which had been excessively dependent on exports to the United States, switched and diversified, and saw the rise of China as an opportunity to integrate more into Asia.'

'Singapore has done fundamental restructuring in developing its service economy. It recognised that there was enormous wealth in Asia that needed a safe harbour and needed to be managed. 9/11, and the way America managed 9/11, meant that the US was no longer as good a place for people to put their money as before, because America, all of a sudden could stop them from taking their money out. So people said that, at a minimum, we want diversification. That was a new opportunity and Singapore picked up on it.'

The other big issue for Asia after 1997, according to Dr Stiglitz, was managing huge inflows of funds, which has led to huge buildup in reserves across the region. He does not share the view put out by many economists that Asia's foreign reserves are excessive.

'If you view reserves as wealth in a liquid form, you can think of them as savings,' he points out. 'So if you ask, 'do we have too much savings,' the answer is no. But if you ask, 'have we invested too much of our savings in low-yield US Treasury bills,' the answer is yes. The point is that those assets have not been deployed as well as one might have liked. They could have been managed better.'

'Now, Singapore is an exception here, because Singapore has been managing its foreign assets well for years. They had figured it out. But some of the other countries are only beginning. China is sitting on some 1.4 trillion dollars, most of which are in low-yielding treasury bills and similar instruments. There's an opportunity to invest them more broadly. There are political and also managerial issues that this raises, but they need to do it.'

One of the political issues faced by the so-called sovereign wealth funds (government-managed investment funds, like those created by China, Singapore, Korea, Russia and some middle eastern countries) is rising financial protectionism. There has been resistance in many rich countries to several attempted investments from Asia and the Middle East. For instance, last year, Dubai Ports' bid for the British port operator P&O which manages many US ports, was blocked by American politicians. China's National Oil company was likewise rebuffed after a political uproar when it attempted to take over the US oil giant, Unocal. Russian companies trying to buy western European companies have also run into political roadblocks.

Although no free marketeer, nor a believer in untrammelled capital flows, Dr Stiglitz has little sympathy for such financial protectionism.

'Let's first take the case of a non-strategic asset - say, a furniture company. Even if some sovereign investor or foreigner owns it and manages it, that should not cause any problem - except if they became a monopolist and owned all furniture companies. But that would be a problem even with a local owner. It's not good for anyone to be a monopolist. So that's a matter for competition policy: if you have strong competition policy, ownership is not an issue.

And what about foreigners or sovereign funds taking majority stakes in so-called strategic assets?

'That can become a more difficult issue,' says Dr Stiglitz. 'But the right way to handle it is to have proper regulatory authorities. For example, if ports are considered a strategic asset and you think it's important for national security to know what's going on, you should have regulators monitoring that.'

'Also, do I necessarily trust an American company to pursue the interest of America's strategic policy, just because it's an American company? No. It's supposed to be maximising profits for its shareholders.

Robust regulatory regime

'Suppose we have an American company that's involved in producing enriched uranium. Their profit maximising strategy might involve selling enriched uranium to a foreign government. Now, I don't want any company to do that, whether it's owned by an American or by a foreigner. I want to make sure there's proper regulation, and if I really don't trust regulation, then I want government ownership.

'But the real issue here is whether the regulatory regime is robust, not whether the ownership is American or foreign. This general distrust of foreign ownership seems to me to highlight the need for better regulatory mechanims, not for protectionism.'

And while the lack of transparency and low disclosure standards of sovereign funds are problems, the same is true for private hedge funds, says Dr Stiglitz.

'If we say we want to have more transparency, and we should, then let's do it for every investor. There is a legitimate argument that anybody investing in the United States ought to be incorporated in the United States and operate according to certain rules, about transparency, bankruptcy, corporate governance. If we believe all that is good, it should apply to everyone. So this goes back to the regulatory construct. I want to make sure that any entity that operates in the United States operates according to certain laws. But ownership? It's not an issue for me.'

Our conversation turns to the issue of the sub-prime mortgage meltdown in the US, which is much in the news. Is the problem more serious than officially acknowledged, and will it spread beyond the sub-prime segment?

Yes and yes, says Dr Stiglitz.

'The sub-prime segment is where you would have expected the problem to show up first,' he says. 'At the heart of the problem was a failure of incentives and accountability. It used to be that if you, as a bank, made a mortgage loan, you kept it in your portfolio. If it was a bad loan, you felt the consequences.'

'What we now have is a 'mortgage originator'. He originates the mortgage, and gets a fee for that, but he doesn't bear the consequences of a bad loan.

'And the investors have not been thoughtful enough about the risks they were taking; the nature of the sub-prime market was to take advantage of people who didn't understand finance. So we have these loans called 'teasers', where for the first three years the rates are very low and there's negative amortisation, so people take the mortgage thinking they'll refinance it in three years, believing the market will go up. The originator tells them, don't worry, the market will be so much higher in three years that you can refinance, take out another new loan at another teaser rate. Yes there might be some transaction costs, but don't worry about those, you'll make so much money that you'll be able to pay it all off.

Day of reckoning

'Well, they were wrong. It was like a Ponzi scheme. Prices couldn't continue to go up. Interest rates couldn't continue to remain low. (former US Fed chairman) Greenspan actually encouraged people to take out these variable rate mortgages - this was when interest rates were at an all-time low, and they could only go one way. Now credit conditions have changed, people can't refinance, and the day of reckoning has come.'

And why will the problem spread?

'The sub-prime mess affects the people who took out 100 per cent mortgages. They are the ones who will have the problem first. If you took out a 90 per cent mortgage, that's not sub-prime. But if the price of your property goes down by more than 10 per cent, it might pay you to default.'

But the more important knock-on effect of the US mortgage bust will be on the broader economy, says Dr Stiglitz.

'The reason why it is likely to have macroeconomic consequences goes back to the role the housing sector and these mortgages have played in sustaining US economic growth, via consumption. The US has had negative savings. How do you achieve that? By people taking money out of their mortgages. If they can't do that anymore, the US can't continue to have negative savings. So if we go from a savings rate of minus 1.5 per cent to plus 1.5 per cent, that's a big change in consumption. It has to slow down economic growth.'

And how bad could it get?

'The magnitude of the slowdown depends on how quickly all this occurs. If we go from minus 1.5 to plus 3 on savings, which would be a return to normal by American standards, and we do this over a four-year period, what you will see is a protracted period of slow growth, but not a recession.

'But if credit markets seize and it all happens quickly, then we could have a stalled economy.'