

Slumdogs vs. Millionaires

What do Wall Street execs have in common with the world's poorest people? Plenty.

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Although it's hard to believe, Wall Street's Gucci-wearing financiers actually have quite a bit in common with slum dwellers in Kenya and Mumbai at the moment—they're both mired in shadow economies, where basic facts like who owns what are nearly impossible to determine. That murkiness, says Peruvian economist Hernando de Soto, is the source of the continuing credit crunch gripping New York, London and other financial capitals, and a basic fact of life for much of the developing world. De Soto, who now runs the Institute for Liberty and Democracy, a global think tank, spoke with NEWSWEEK's Barrett Sheridan from his office in Lima. Excerpts:

NEWSWEEK: Your bestseller, "The Mystery of Capital," tackles the idea of property rights and their impact on economic development.

Hernando de Soto: What makes a market economy possible is that people are able to find out facts about each other and about their enterprises in spite of the fact that they don't have direct physical contact. So the question is, how do you get to know things? How do you get facts? You will find out that most of the facts you want are in property papers. One of the things that developing countries miss is that close to 80 percent of their enterprises are actually not fully recorded as property.

And the simplest way in which this idea takes shape is that a lot of poor people in the developing world don't have deeds to their houses.

They don't have recorded deeds. They may actually have a deed, but it's not in the knowledge system, therefore you can't read about it.

So this knowledge of who owns what is not standardized.

It's not standardized and it's not distributed. I may have a manuscript here that actually says—from the King of Spain—that ever since the Spaniards landed in Peru, I own this land. But you may not know about it unless I record it.

Why does ownership matter so much?

Ownership means that I have something to lose. If you're a banker, it means that you've got collateral. It also means that I'm credible, so you can give me credit. When you think about it, whether it's ownership, whether it's credit, whether it's capital, whether it's identification, none of the things that make a modern economy are possible without property.

How does this relate to the financial crisis?

The enormous amount of derivatives that had poured into the market—there are close to \$600 trillion of these papers around—are also not recorded in a global or centralized manner, or in a manner that allows you to begin to quantify them. [Former SEC Chairman Christopher] Cox thought that maybe the toxic part of all of these assets was \$1 trillion to \$2 trillion. [Treasury Secretary Timothy] Geithner told us there's maybe \$3 trillion or \$4 trillion. Nobody really knows, so in a way [they've created an] informal or shadow economy. This unidentified paper is the source of uncertainty and the credit contraction.

So they're unidentified in the same way that ownership of, say, a slum in Peru or Africa is unidentified.

That's right. We have worked in places like Tanzania and Egypt and Ethiopia. When you go visit a home there you don't find justification for it through the books. In other words, it's not centrally available information. When you talk about shadow economies in many places, it's not only the economy of gangsters. It's also economies that are legal in every respect except for the fact that the paper, which backs up the ownership or the evidence that something exists, is not easily and publicly available. That creates the shadow.

Has the subprime mortgage market become a shadow economy?

Subprime mortgages are not a shadow economy. But what happened is that a lot of these mortgages got repackaged into securities. Then they became collateralized debt obligations and some of these mortgages were sliced and diced and put into tranches. When some of these mortgages went sour and people started defaulting on their payments, then of course a lot of the securities tied to them also started defaulting. But when you try and trace who's ultimately responsible for the value of that paper, you couldn't find it. That's the part of the market that has become the shadow.

So basically ill-defined property rights in the subprime mortgage sector caused a meltdown. Does the same happen in the developing world?

Yes. That shadow hopefully is a temporary condition in the United States and in Western Europe. And it might pass in a year or 10 years, but it will pass. That passing condition that's occurring now in developed countries, that's a chronic condition in developing countries. We're always chronically in credit crunches—because you don't know who owns what, nobody dares lend to somebody else. Bringing the law to emerging markets is possibly the most important measure that can be taken to help these countries become rich. Look at the Iranians, look at the North Koreans—they're building nuclear plants. Look at the computer—they're being built in northern India. The issue isn't the expansion of technology. We can all get it, borrow it, buy it or steal it. The issue is how do you get a legal system that allows people to cooperate so as to create more complex systems and objects.

So at this point, a Wall Street banker in a \$10,000 suit is encountering basically the same problem that Nairobi slum dwellers have had to deal with for decades or more.

Absolutely. The difference, however, is that in Nairobi they are still struggling to understand that a property system is the best way that they can do things. In the United States, every piece of land, every house, every automobile, every airplane, every manuscript for a film, every patent is written up and recorded and described. There's only one thing in the United States which is not recorded in such a way and that's derivatives. We're only talking about 7 percent of the subprime market being in default, yet it is causing a major contraction in your economy. You're not getting your credit flowing because you don't know what is where and who it belongs to.

What's the answer? How do we assign "property rights" to derivatives?

The banks and the holders of all of these instruments have got to report them in such a way that your government and the public knows who owns what and where. Once the light shines, you will know who's solvent, who's insolvent. You'll be able to have a clean debate as to who to help and who not to help. And you're going to have a much better idea of the consequences of not helping or helping. Right now you're talking about all of those issues, but you still don't have the facts. So the first thing is to have the law require those people who own these things to fess up.

It sounds so simple when you put it like that, but I guess there are special interests blocking that from happening.

I am convinced that there are special interests. Creating property rights in the United States [was much easier to do], because a lot of the land, the assets, the woods and the rural areas actually belonged to nobody, or they belonged to indigenous people or Mexicans. But in Britain, those who owned property were able to resist registration throughout part of the 19th century. They even argued that public knowledge of who owned what could eventually lead to kidnappers or things of that kind. And they managed to avoid the light being shined [up until 1925]. The fact is that a market economy works on information. If you don't have the facts, you don't have a market and you can't have justice.

Have we in the West forgotten that?

Einstein was credited with having said, "What does the fish know about the water in which it swims?" You've got to be a human being and look at it from the outside—then you'll understand why the fish lives where it lives. So I think what's happened is that Westerners got property [rights] very early on, about 200 years ago if you're American, and you've grown accustomed to it. You're the fish in the water.

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