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Knowledge lies at the heart of western capitalism

By Hernando de Soto

The world economy is made up of many tiny parts that are useful only when we combine them into more complex wholes. The higher the value of these aggregations, the more economic growth. Humanity's achievements – from the 120 ingredients of my clock to the countless financial deals and developments that produced the internet and flight navigation systems – all result from joining people and things to each other.

That's why western capitalism has triumphed for the past 150 years: it gave us the best knowledge to explore economic combinations. Capitalism does not need to be re-thought or re-invented; it simply has to be re-discovered.

The reason credit and capital have contracted for the past five years in the US and Europe is that the knowledge required to identify and join parts profitably has been unwittingly destroyed. The connections between mortgage loans and liquid securities, between non-performing financial derivatives and the organisations that hold them; the non-standardised, scattered records that obscure who holds risks; and the off-balance-sheet accounting that obscures many companies' health: these all make it harder to trust and hence combine. Until this knowledge system is repaired, neither US nor European capitalism will recover.

Reformers and policymakers must recognise that they are not dealing with a financial crisis but with a knowledge crisis. Capitalism lives in two worlds: there is a visible one of palm trees and Panamanian ships, but it is the other – made up of the property information cocooned in laws and records – that allows us to organise and understand fragments of reality and join them creatively.

The world of organised knowledge and joining began in earnest in the mid-19th century, when reformers in Europe and the US concluded that the segmented, undirected knowledge left by the old regimes could not cure the recessions that beset early capitalism. They faced what was known as “the knowledge problem”, the inability to select and store dispersed information about economic things. Those reformers created “property memory systems” to map – in rule-bound, certified and publicly accessible registries, titles and accounts – all the relevant knowledge available on assets, whether intangible (stocks,

patents, promissory notes) or tangible (land, buildings, machines).

Knowing who owned – and owed – what and where, and fixing that information in public records, made it possible for investors to locate suppliers, infer value, take risks and combine such simple things – to borrow a famous example – as graphite from Sri Lanka and wood from Oregon into pencils.

Reformers also helped to solve “the binding problem,” finding the information needed for parts to fit together. This metaphysical concern affected all disciplines: physiologists discovered that what binds cells to form an organ performing specific, sophisticated functions is a nucleic acid now called DNA. The logic behind the property documentation is the DNA of capitalism.

Modern recording systems evolved from data warehouses certifying isolated assets, into factories of facts for facilitating the knowledge entrepreneurs need to combine assets, skills, technologies and finance into more complex and valuable products. Thus, real estate documentation no longer just says that Smith owns the house on the hill but also describes that house as the address at which mortgages can be foreclosed; debts, rates and taxes collected; deliveries made; and from which utilities services can be controlled and bills collected.

This knowledge allowed western economies to grow more since the second world war than in the previous 2,000 years without big credit contractions.

Until 2008, when we began to learn that memory systems had stopped telling the truth – through off-balance-sheet accounting; debts buried in footnotes or the ledgers of “special purpose entities”; financing raised by “bundling” mortgages into securities not recorded in traditional public registries; and nations masking debt as income by swapping it from one currency to another. No wonder institutions and investors have lost confidence in the system.

The brilliance of western capitalism lies not in providing a formula for wealth creation but in its property memory systems, which are the result of examining, selecting and validating information about who owns land, labour, credit, capital and technology, how they are connected and how they can be profitably recombined.

For the past 15 years, the records of western capitalism have been debased, leaving governments without the facts to spot what needs to be fixed and for businesses to know where their risks are. To regain its vitality, western capitalism must bring under the rule of law and public memory hundreds of trillions of dollars now swirling mindlessly out of control in the obscure world of financial innovation. That task requires major political leadership.

The writer is author of 'The Mystery of Capital' and 'The Other Path'

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