

# Grano Series – The Future of the Global Economy

*The 5th<sup>d</sup> annual speakers series, held in Toronto at Grano Restaurant, explores the challenges of the global economy given the world-wide recession and stock market collapse of late 2008-09.*

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## **Its still about property rights**

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*The following is an edited transcript of Hernando de Soto's talk at the Grano Series. Mr. De Soto, who heads the Institute for Independence and Democracy in Lima Peru, is also a best-selling author - including his latest book "The Mystery of Capital".*

**T**he global economy is inseparable from the word "recession." We're in the middle of one, though I know the news lately has been good. But the reason I do feel comfortable talking about this, I finally told myself, is because I actually live in a recessionary economy, a country with a permanent recession. So I know recession, because it's a constant credit crunch. In my country, people don't get credit because we're not documented. How can you trust somebody when you don't know where they live and you don't know where they work? This is what happens with 89% of Egyptians, 98% of Tanzanians, 50% of Peruvians, 70% of Mexicans, and so forth. We're always in a credit crunch. That means that we're in a very good position to understand why credit doesn't work.

Credit comes from the Latin, "credere," which means to trust or to believe. Look at it this way -- we are a world of about 6 and a half billion people. There's no way we can know each other. The other day I lost my Blackberry, where I have all the records of the people I know. Now, I remembered that before passing from writing to the Blackberry, I had sat down with my secretary and we had taken out all my notebooks from over the years and -- at that time it was a Palm Pilot -- she said, "You know, we can only have about 2500 entries and you have something like 6000/7000 names." So I thought that on a plane trip to Africa I could just check all the names one by one and make decisions about who to leave out. I thought it would be a trip down memory lane. At the end I found out that I couldn't remember more than 2000 people. So obviously you do need a lot

of information. You do need to know who owns what, who lives where, and that is crucial for the economy and for the economy to grow.

What has happened lately is that in the global economy we have about 13 trillion dollars worth of bank notes and coins. That's how many dollars there are, U.S., Canadian, Euros, and you've also got, in terms of paper -- which is actually the way credit flows -- bonds and equity to the tune of about 170 trillion dollars. That's the kind of paper we use to lend to each other, to believe in each other. In the last seven years, especially in the United States, the UK and certain other Western countries, they've issued another type of paper called derivatives. Now, they'll tell you that derivatives have nothing to do with assets, but when they want to rescue them they do call them assets, troubled assets. So they are assets, because we use them to talk about other people's wealth.

The latest calculation by the Bank for International Settlements is that there are about 1 quadrillion 200 trillion dollars worth of this new kind of paper. In other words, it absolutely simply dwarfs anything else. And don't forget that we are a global economy that rides on paper. There isn't one thing that you own of value that isn't on a piece of paper. If I asked you right now about your house or your car, you would refer to a piece of paper. If you wanted to give me your car and you said, "I'll give you my key," I would say, "Give me the piece of paper. I'll take the piece of paper I'll figure out the key later." It's a piece of paper that tells you if you own something or if somebody owes you something. All value travels on paper and all of a sudden, in seven years, we have produced one quadrillion dollars. Now, how much is that?

Well, if you had earned about \$100,000 a day since birth, you would get your first billion dollars when you were 32-years-old. And if you want to earn a trillion dollars during your lifetime, and you had been born receiving a \$100,000 a day, you would have had to have been born 32,000 years ago. And if you want to earn a quadrillion dollars, earning \$100,000 a day, you would have had to have been born 32 million years ago. That's how much we've got of this paper. It's out there. So the way I see it, knowing how important paper is to make a modern economy work, I don't care how good the news is of late. Until that problem of representation is dealt with we won't be out of the woods.

What governments have been doing has consisted of bringing in money -- trillions of dollars of money -- to banks and their balance sheets in order to send the message that you can trust the banks, because governments are right behind them. Up to a certain point it works. It's obviously working and producing some kind of rally. I don't know how long it's going to last, though. Maybe it'll last for a good amount of time, maybe it'll last for a short amount of time. But let me tell you why I feel that a lot of this is done in ignorance of what it is the West has built over the last 200 years that is worth cherishing. And the reason I feel that I have -- and

this might be presumptuous – some authority in talking about it, is because I remember Albert Einstein's phrase, "What does a fish know about the water in which he swims?" You've to be on the outside to understand. So I'm going to try and tell you what I see that has been done over the last 200 years, which in this recession is being particularly threatened.

First of all, recessions we've always had. Throughout the 19<sup>th</sup> century there was a recession roughly every ten, fifteen years. They lasted, on average, about six years. So we've learned a bit about recessions. The last recession we had was from about 1929 till after the Second World War. And what helps me understand these recessions is not talking to present-day North Americans, or present-day Europeans, about them, but rather reading what those who built up the Western system as we know it wrote about, when they were under stress. It's when under stress that real things come out. I mean, I've been known to say at a certain moment, I'm going to leave whatever money I've made to this girlfriend or to this old friend, but the moment I know I'm about to die, I start saying I'm going to leave it all to my mother. Things change when you're under stress.

And here's what certain people said when they were under stress, especially during the last recession. Both Alfred Marshall – that was at the end of the 19<sup>th</sup> century – and Friedrich von Hayek – during the 20<sup>th</sup> century – said that one of the parts which is really missing in economics is that we haven't explained how it is that we know things. We haven't factored it in and it's a very important part of the whole explanation. That's what John Galbraith also said just after the last recession. He said that we haven't figured out how it is that we over-spend or under-spend. We don't know how we get the facts. What I think has happened in the West – understanding myself as a Westerner or an inheritor of the Western tradition – is that we have learned a way of understanding facts that we ourselves don't totally cogitate. And it's important to understand these things.

During the 19<sup>th</sup> century the idea of epistemology – how we know things – was central. Actually, it was central to most thinking beginning at the time of Immanuel Kant. Kant said that how you write things on paper is crucial, because what paper does is give you the capacity of committing. So you have to learn to be precise, because the respect of paper is crucial. Charles Sanders Peirce and Ferdinand De Saussure also went down the same road. They said that what appears in signs is crucial because that's the way that we move around. And if you think about it, everything that we do during the day is directed by signs. I got to the airport in Lima by reading the signs that said "go left" or "go right." There were red signs that meant stop and green signs that mean go. You get to the airport and you see arrivals or departures. You go one way or the other, they give you

your gate number, you go to your gate number. Everything is a sign as you go along the way. We process signs all the time. You're sick. The doctor takes out his stethoscope and he listens to signs. He doesn't get into your heart. He listens to signs. He listens for a murmur or he listens for a gurgle. Those signs will tell him something about your heart and lungs.

We look for signs all the time. We interpret signs and the reason I think Westerners have gotten ahead so much more than the rest of the world is that they've become excellent at signs. They've been able to produce one of the most sensational sign systems in the world. And the people who probably most understood this were Bertrand Russell and Ludwig Wittgenstein, who said that the world is full of atomic facts. I mean, it isn't a question of knowing where things are. It's all about facts. Can he pay? Can he not pay? Is it risky? Is it not risky? These are facts. Am I going to make a good investment? Is this a good person to give a salary to? Can we make a deal? Can we not make a deal? These are facts you've got to know. And he said the trouble is that facts don't exist naturally. What exists naturally is what Wittgenstein called "sachverhalte," or Bertrand Russell called "little patches of colour." Another term for these is "atomic facts" -- little bits of things that in isolation don't mean much to us, but together give us a picture, a sign. Take the periodic table, with 117 elements, including hydrogen and oxygen. Per se, that doesn't tell us too much, but if we see it together as H<sub>2</sub>O, as water, then we understand it. When the fact is useful we can grasp it. So what the West has managed to do is bring facts together in such a way that you can read them really fast.

So for example, when I got here to Canada and I went through your customs control, I was asked who I was. I said, "I'm glad you asked me that. I'm the son of Alberto Soto de Hara and Rosa Pollar and we actually came from Spain and the other people came from Milano..." and he said, "Stop. Just show me your passport." He got the facts. He went through the passport and there were a lot of little atomic facts, but they're put together in such a way that this person just checked away and had the facts. At a certain moment they asked me what I was going to do here and I said that I was going to be at a conference and they passed me to another place where they asked whether "conference" meant I was going to be doing illegal work in the country. They decided it wasn't. The facts came out, very quickly.

And the West has got facts on paper. So that's one very important part. It's got all the good sign systems. But it doesn't only have that. It's also got standards, which are very important. You can only look at one person and compare him to another person if they respond to the same signs, like my passport. In the West, you started that way back in the 19<sup>th</sup> century with electricity. Standards began with electricity. The United Kingdom had about 300 systems of voltage, and then it was decided that

what was really needed in order to become a country was one voltage, one plug, one nation. And then other Western nations began standardizing their voltages. So now you can distribute electricity, you've got documents which tell you whether you're in debt, you're not in debt, you've got identity documents, you've got maps which are all done to scale, you've got an incredible sign system. It's so easy to move around and understand these things.

My specialty is shadow economies in the Third World where you don't have anything like that. It's the same with time. Just about 150 years ago, noon was when the sun was up there, at midday. That was noon. So it was noon in Wichita Falls and it was noon in San Diego and it was noon everywhere, until they convened this general conference in Greenwich at the end of the 19<sup>th</sup> century. They agreed that there was a zero hour and that it was going to be Greenwich Mean Time, and that then you would divide the rest of the world into 24 hours. As a result, everybody can navigate and when you say, "I'll see you at 3 p.m. tomorrow in New York," everybody knows what it means.

But you haven't only done that regarding time and electricity, you've also done that regarding value. That's essentially what globalization is about. The world of globalization is about us having international standards. Two billion of us can participate in the global economy, provided that we've got these signs that we can trust. And the West has another thing that has been done enormously well over the last 200 years, but especially over the last 60 years, which is that everything has been committed to a memory bank. There isn't one piece of land, one building, one boat, one airplane that in your countries isn't recorded. You know where it is and it's got a serial number. There isn't one piece of equity or one bond that is not recorded. Everything is in public memory. So as a result of these three things, that you've got the same sign system and language, you've got the same standards, you've got everything in memory banks, you can then have a global economy and you can trust each other.

There's a tendency of all you gringos north of the Rio Grande to start saying, "Well, there's that economy you're talking about, Mr. DeSoto, but then there's the real economy. The real economy is hard working people, our rivers, our resources and we've got two oceans." Well, Mexico has two oceans, too. The difference between you and Mexico and the Central Americans who have got two oceans is that your real economy is really the paper economy. In other words, there's Mother Nature, who has created a common heritage of humankind, but there's also the world of signs and symbols and languages. We human beings are also world-makers. It isn't only Mother Nature.

As a matter of fact, you wouldn't have been able to preserve nature if you didn't have the sign system. We watch television and we see that

there are 16 cases of the Swine Flu or N1H1. And then we see the number rises to 18 cases, then 19. How do you get to know that? How do you know that it's strong in Mexico and weak in Russia? How do you know that? You know it through your sign system. You've got everything in records so you can fight diseases and you can fight inflation because you've got this wonderful sign system that is standardized and that is well recorded. How do you know the earth is heating up? Your signs -- you've been measuring temperature and you've been recording it and on top of that it can be centigrade or fahrenheit and you know how to convert one to the other so we can all agree that it's warmer.

To me, this sign system is the global economy. And what I do is work with what I call the informal economy -- in developing countries. This is a most important issue because four to five billion of the world's population live in that kind of economy. I work on the Commission on the Legal Empowerment of the Poor at the UN. I co-chair it with Madeleine Albright and we work with, among others, Larry Summers and Gordon Brown. We work towards bringing all of these four, five billion people inside the sign system so that we can talk to them in the same language and we can then give them the benefits of having signs. You can't have credit without having signs. You can't have capital without having signs.

Has anybody of you ever touched capital? It's like touching energy. It's not a thing, it's a concept, and the only way you can capture it is on paper. If it's on paper and it's got measurements then you know how much capital you've got and you know if there's energy. You can calculate it in horsepower, you can calculate it in voltages, there are a hundred ways you can calculate it. But it's all done through signs and four to five billion people in the world don't have these signs. And they're in all the hot spots of the world -- Iraq, Afghanistan -- wherever you've got a guerrilla there are people without signs. You can't talk to them. They've got to come into the system. And this is the only system so far that works. The question is how do you make that transition while you yet respect their cultures?

But you've got to get them inside the sign system because this is the first time in about five thousand years that we've all been able to agree on a sign system. It's absolutely extraordinary. The Romans had their signs, the Egyptians theirs, but none caught on. This one has caught on.

And then, all of a sudden out of North America -- not so much you but the United States -- and out of the UK came one quadrillion, 200 trillions dollars worth of signs that dwarf everything else. And instead of trying to get the financial toxicity out of the way, so that we can understand who we can trust, the system has reacted by saying, "Nah, that's kind of tough. Let's not count it, because it's difficult to count." That's not true. We can count anything. I can count how many informal properties there are among the Maasai in Tanzania and come out with a

clean number. You can do it here, too. If you can have a rock fall -which is what we were talking about with Peter Munk before – and all of a sudden you see the fossil signs of a dinosaur that lived ten billion years ago and you can build a whole new one just on the basis of that, we can find out who's got the toxic weight. We're not getting there, though because we're scared that we might find something we don't want to find, or that it may break this bank or that other bank.

So we've decided to do something different. We've decided to toss money at it -- which, of course, works. It's the Keynesian formula. If you toss enough, what you're telling people is that the government is behind the banks. But you've still got these quadrillion dollars, but we don't know where it is, who owns it or holds it, and we're not getting into it because we're scared to know.

It's interesting. I thought the people who were scared about statistics were supposed to be Islamists. They were supposed to be Communists. This is the capitalist Western system that doesn't want to look and that scares the hell out of me. It means that there are things that are out of control that we are trying to beat back with faith. Trust in the American economy. Trust the two oceans. Trust our resources, trust our capacity to work, we've done it before. You may have done it before, but if you're scared because there's money laundering by narco-terrorists in Mexico to the tune of maybe ten billion dollars, why don't you do something about these quadrillion dollars? Something is bad here, something is wrong.

And that's why, while there might be good news about the economy, I still have my doubts as to how far we're going to get until we remember that the market economy -- social democratic, Christian democratic, whatever you want to call it, to the left, Obama-ish, George Bush, it doesn't matter -- as it is, is a system that works on signs and standards. But now we've got no standards. We've tried to find out how many of these credit default swaps there are – so far we've been able to count about 131. There are no standards. We've tried to find out if there's a central recording system. There is no recording system. We've tried to find out if they're fixed, like your house, like your automobile. We don't know. We've tried to find out if they're updated. Nobody's updating them. There was no record-keeping system to begin with. We've tried to find out if they're fungible. I don't know. What is their real price? Well, they've just decided that there was a pricing system called mark to market, and now standards have been taken away. I guess it's now mark to imagination.

The banks can tell you what it is they want, and then they say if you've got too much of this bad paper we've got something that's called special purpose vehicle. We'll take all the bad stuff and put it there for a while. That's okay because it's perfectly legal. It's all perfectly legal. That's what drug traffickers do in my country. It really isn't very helpful because

it means that you don't know what's going on and it means that the next time you get a bubble you don't know what's going to happen. This bubble, as far as I can tell from distant, darkest Peru, was essentially a sub-prime bubble. And Secretary Paulson, in October 2008, asks Congress for 780 billion dollars to do something called TARP, or Troubled Asset Relief Program. Ten days later he comes back and says that instead of TARP, he wants to help the balance sheets of the banks. Why did he do that? My guess is he couldn't find them, he doesn't know where they are. To find them he would have to report them. And they're not ready to do that. We don't know where it's at.

The bottom line is relatively simple – we're not out of the woods until we restore faith in the written word. How can you diagnose anything in the world -- from cancer to pneumonia to swine flu to inflation to deflation -- if you don't have knowledge of the paper involved? Don't forget, money isn't credit. Money is something separate from credit. Money helps to give you the right to leverage, but credit is made out of derivative paper, it's made out of equity paper, and that's what we don't keep track of anymore. So you're beginning to look a lot like us. And I know the system. When things go too far down this path you have a country that you can't run. Everything else that you've got, all the paper that you've got in the West is essentially a statement about something. It's a statement about an asset, it's a statement about a fact, and you've built up all your micro-facts into useful facts. Now you've created a very dangerous world of statements about statements about statements. And you're lost.

You know, there used to be a time in old Peru when sailors didn't know how to navigate by the stars. The way you would navigate was in relation to the coast. Then there would be a second line of ships that didn't know where the coast was but knew where the first line of ships was and then there would be another line of ships that didn't know where the coast or the other ships were...until everybody started getting lost. I wish I had a nice message for you but I think at least I have an interesting diagnostic.