FOREWORD

By Barun S. Mitra, Liberty Institute (India)

The crisis that has shaken the financial world over the last two years is ascribed to many failures – from easy money, human greed, or a lack of government oversight to the lethal financial derivatives created by financial whiz kids. While relevant, much of the public discourse has ignored a fundamental cause of the present economic woes. In my view, this financial crisis is the consequence of distorting or altogether disconnecting the relationship between property and ownership.

A modern economy is built on clear ownership of property whether tangible or intangible – be it land, shares, or intellectual property. It requires a commonly accepted form of documentation of that ownership, an easy method of trade of ownership and transfer of property, and an unencumbered market where the transactions can be undertaken leading to the discovery of the price of the asset concerned. Once that chain of ownership is lost, it becomes almost impossible to assess the real value of the asset.

Hernando de Soto, the noted economist who unveiled the secret of property in his book *The Mystery of Capital*, recently wrote:

> Look around: everything of economic value that you own – house and car titles, mortgages, checking accounts, stocks, contracts, patents, other people's debts (including derivatives) – is documented on paper. You are able to hold, transfer, assess and certify the value of such assets only through documents that have been legally authenticated by a global system of rules, procedures and standards. Ensuring that the relationship between those documents and each of the independent assets they represent is never debased requires a formidable system of legal property rights. That system produces the trust that allows credit and capital to flow and markets to work. (De Soto, 2009)

The first time bomb that exploded in the dramatic chain of events leading to the financial crisis was the U.S. housing market. It had long been in a boom phase supported by public policy aimed at widening home ownership and facilitated by an elaborate network of financial institutions. Whether owned by the U.S. government (such as Ginnie Mae), implicitly supported by it (such as Fannie Mae and Freddie Mac) or entirely private, these institutions created an ever more elaborate chain of securities that funneled savings from across the world into securities that were issued against mortgages taken out by U.S. homeowners.

Originating in single, often modest loans taken by U.S. families, these mortgages were packaged by banks into so-called MBSs (Mortgage-Backed Securities). Beginning in a small town in Texas, for example, a retail bank would bundle its mortgages and transfer them to a regional office. Within days, often hours, the paper would find its way to New York where one of only six rating agencies would slice the bundles into layers of securities. The rating agencies would determine what proportion of the securities should be rated AAA (the safest, with correspondingly low interest rates) based on statistics of housing loans over the earlier decade and how the remaining paper should be pegged down the ladder of safety – and up the ladder of return.

Thus rated, the paper would be offered to buyers across the world – whether banks, hedge funds, or pension funds. Having traveled at the speed of the Internet from a U.S. suburb to a small town in Germany, the securities were essentially 'virtual' in nature. The savings institution in Germany had no way to assess the risk underlying the paper it owned except via the rating stamped on it in New York. This risk assessment was frozen in time and in turn derived from a series of historical default rates generated during a period when U.S. home prices were on a steady upward path. When the downward slide began as often happens with all asset booms, there were no reliable mechanisms to reassess the risk underlying the securities.

The current financial troubles illustrate the tragic consequences if the relationship between property and ownership is blurred. For instance, the stock market operates on the basis of the continuous disclosure of financial performance of companies and has the facility to trade such information in comparison to other assets. These institutions allow for the price of the asset to be discovered. If the chain of ownership is lost, it becomes almost impossible to assess the real value of the asset. This is precisely what happened with the MBSs.

It seems quite clear that the political attempt to promote housing in the U.S. and easy money policy stimulated the growth of new financial derivatives by repackaging many doubtful mortgages. As on earlier occasions when snake oil charmed the investors of the 19th century or the seduction of the French by the Louisiana Company in the 18th century, the housing boom in the U.S. in the early 21st century apparently created such a sense of euphoria among investors that they failed to keep tabs on the paper trail of ownership. Thus, investors lost track of the real value of the underlying assets. But unlike in the previous centuries, today, real estate is a much smaller part of the broader economy. Also, the world economy is presently much more integrated and, therefore, dispersed and diverse. Consequently, the world economy seems on a recovery course in less than two years despite the economic turmoil.

While world attention is focused on the economic situation in the U.S. and other developed countries, the situation also underscores the perpetual economic crisis in many developing nations and poor communities. In these societies, recognition of property rights and respect for ownership are weak, and a title document is often non-existent. Typically, these are places where informal economic activities dominate. But the consequences are very similar in both – lack of credit. The ironic problem of the poor is not that they do not have assets; instead, they are unable effectively to capitalize their assets. The present crisis demonstrates that the rich are equally vulnerable to being unable to capitalize their assets if they lose their connection to the real economy and the clear titles that it requires.

Fortunately, the developed countries that have a well established system of property rights are in a much better position to deal with the present turmoil. Despite all the talk of this being the most serious economic crisis since the great depression of the 1930s, one has not seen the streets of London or New York lined with the unemployed or impoverished outside soup kitchens. The enormously larger capital base in these countries today enables them to tide over the crisis with very little disruption. The problem seems to be that even these relatively small disturbances in an otherwise tranquil and predictable economic environment greatly magnify the perception of these disruptions, as the former stands out sharply in contrast to the latter.

Unfortunately, by this very similar process of perception, the perpetual economic crisis in poor countries where millions of people struggle to survive in an informal economic environment are seen as the norm rather than the exception. Unlike their counterparts in developed countries, the poor in less developed nations are paying a very real price for their inability to grow out of the informal economy – at times paying even with their lives.

A critical component of a functioning and stable system of property ownership is the property registration system. Typically, the government is the sole agency that surveys property, registers ownership, and issues the title deed. In such a monopolistic environment, it is not surprising that many governments tend to behave as rent seekers viewing the property registration system as a way to maximize revenue. By contrast, the registration system should be an instrument for providing protection, facilitating transaction of property, and enabling its capitalization. The present crisis in the rich world and the perpetual crisis in the poor world should encourage us to look for alternative ways of recording property.

For instance, all property, particularly tangible physical property like land and structures on it, is situated locally. Could the local community, with the support of agencies like banks and insurance companies, and private surveyors undertake the process of recording and registering property in a more efficient manner? One of the additional advantages of such a localized approach would be for local people to gain a much better understanding of the need for recording and formalizing property ownership.

The present economic crisis, with its root in housing and property, provides a very good opportunity for people in rich and poor countries to take a fresh look at the significance of property rights and to renew our appreciation of a system of formal ownership of property. The 2010 *International Property Right Index*, a unique comparison of some of the key parameters measuring different aspects of property rights, therefore, acquires special significance in the current economic environment.

I hope future issues of the IPRI report will explore the possibility of including new parameters to better capture the information regarding recording and registering property and make it even more relevant for the people across the world.

Reference List

De Soto, H. (2009, February 21). Toxic paper. *Newsweek*. Retrieved from http://www.newsweek.com/id/185814