

School of Management and a cofounder of the economics blog Baseline Scenario. Johnson puts De Soto in the same category as Muhammad Yunus, the Bangladeshi economist who won a Nobel Peace Prize as an exponent of microcredit.

In his 2000 book, *The Mystery of Capital*, De Soto estimated the amount of dead capital in the developing world at \$9.3 trillion. As he observed in a recent paper, “for shadow economies outside the U.S. and Europe, ‘meltdown’ is a chronic condition.” So can the chronic meltdown of poor nations tell us something about the new meltdown in the West? De Soto thinks so. “Developed countries, especially the U.S. and western Europe, have produced an enormous amount of paper that represents assets that are unaccounted for,” he says. The Bank for International Settlements put the total notional value of outstanding derivatives at \$591 trillion at the end of 2008. But while the BIS and others try to come up with such estimates, the location, ownership and value



Hernando de Soto pushes for transparent property rights in developing countries.

of outstanding derivatives is not well tracked. As poor nations were coming to understand the benefits of a fully documented and transparent system of property rights, a portion of the U.S. economy was becoming untethered from the paper that represented it.

“The amount of paper you have in America and western Europe that is unanchored to anything that you can put your hands on is enormous,” he says. “Why should you be listening to me, a Latin American? Because we know something about flooding a market with paper.” He’s alluding to such crises as Argentina’s repeated bouts with inflation or the loose lending that precipitated Mexico’s 1994 financial crisis.

U.S. banks went beyond simply lending to unworthy creditors. The increase in the number and kind of derivative contracts—including some, like credit default swaps, that were traded over the counter rather than on exchanges—created a new kind of shadow economy, De Soto argues. “It reminds me of the way we used to navigate on the coast of Peru,” he says. He explained that you’d have close-in sailors navigating by keeping an eye on the coast, then farther-out sailors who navigated by watching the boats that were watching the coast, and so on. “Somehow you got very far away from the coast.”

In letting the derivatives market grow to the size it did with little tracking or transparency, De Soto says, Americans breached a law so fundamental that it is unwritten. In the West, ever since feudalism collapsed, “the market made an effort to record everything so that paper meant something,” he notes. This happened without the mandate of any central government. “If I asked you, where is the ministry of property in the U.S.? You’d say we have no ministry of property. Sometimes you don’t need it.” Yet title to

every house, car, mortgage, bank account and patent had always been reliably documented. “It’s not a fundamental law written into your constitution but an unwritten law that you have not respected, which is that paper means something,” he says.

This notion that the legal invisibility of part of the derivatives market played a role in the crisis now has wide acceptance. The Obama Administration has proposed moving most derivatives trading onto exchanges in order to encourage transparency, and a bill that would do so is wending its way through Congress. The European Commission is also considering new derivatives rules.

Transparency might delay the next meltdown. But what do we do to extricate ourselves from the last one? “I think that all the causes of the recession are still around, and on top of that, somewhere along the line we should fear inflation,” he says. All devalued paper, be it in the form of cash or other instruments, is in De Soto’s

view inflationary. Between stimulus dollars and toxic paper, the U.S. has both.

Although De Soto spent much of his childhood in Switzerland, where he also earned graduate degrees in economics and politics, he identifies strongly with his native Peru, peppering his writing and speech with phrases like, “as I see it from the Southern Hemisphere.” His concerns about the wider world economy also lead back home.

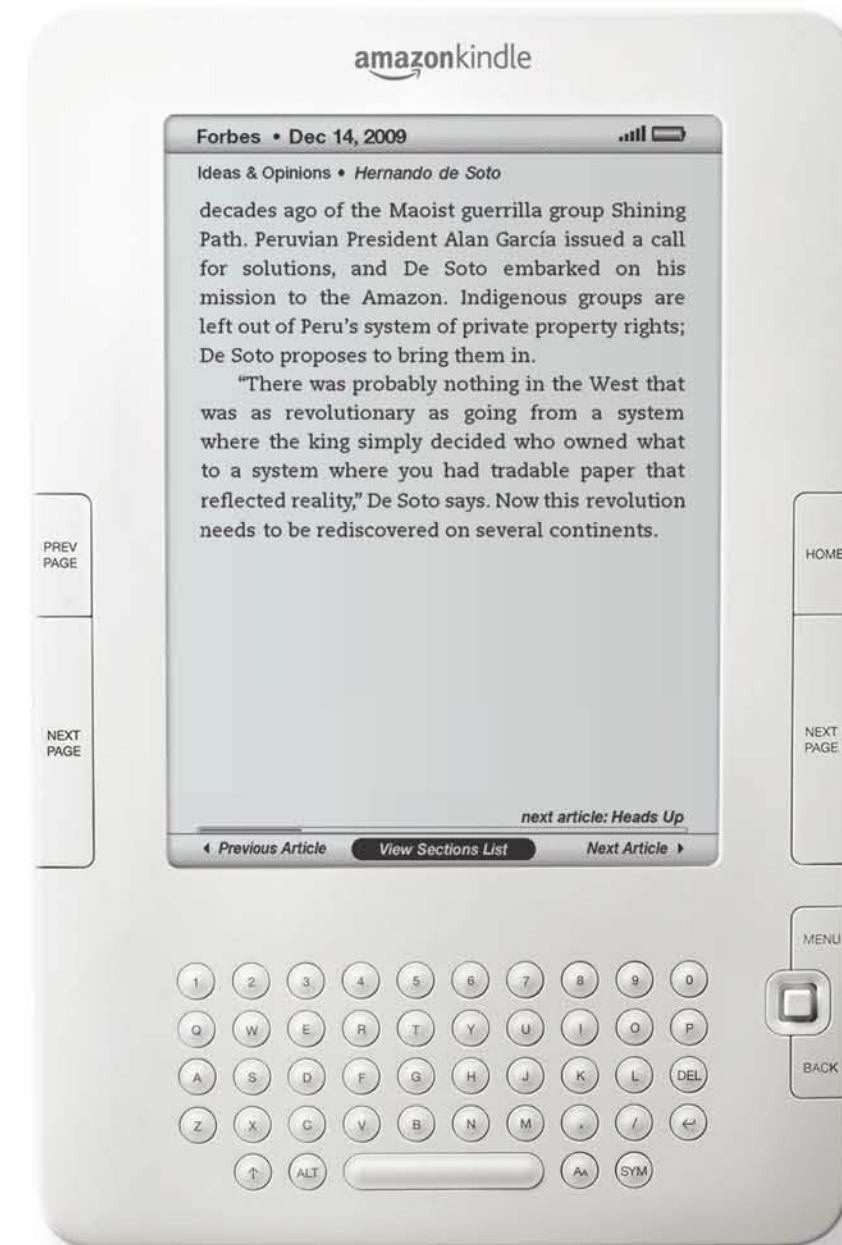
The devaluation of cash and paper contributes to what Ludwig von Mises (1881–1973) called the “flight into real values,” as investors shift into real estate and commodities. That, De Soto says, is when everybody starts eyeing developing countries for their hard assets—in the case of Peru, for copper, gold and natural gas. “Then all of a sudden you start finding out that every time you drill a hole it happens to be on someone’s illegal property, and this is when all hell breaks loose.”

In Peru’s Amazon region in June police clashed with indigenous groups who were protesting laws that opened the region to mining and oil exploration. At least 34 people were killed, the worst bloodshed the country had seen since the heyday two

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Continued from page 22



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