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The Destruction of Economic Facts

Renowned Peruvian economist Hernando de Soto argues that the financial crisis wasn't just about finance—it was about a staggering lack of knowledge

By Hernando de Soto

During the second half of the 19th century, the world's biggest economies endured a series of brutal recessions. At the time, most forms of reliable economic knowledge were organized within feudal, patrimonial, and tribal relationships. If you wanted to know who owned land or owed a debt, it was a fact recorded locally—and most likely shielded from outsiders. At the same time, the world was expanding. Travel between cities and countries became more common and global trade increased. The result was a huge rift between the old, fragmented social order and the needs of a rising, globalizing market economy.

To prevent the breakdown of industrial and commercial progress, hundreds of creative reformers concluded that the world needed a shared set of facts. Knowledge had to be gathered, organized, standardized, recorded, continually updated, and easily accessible—so that all players in the world's widening markets could, in the words of France's free-banking champion Charles Coquelin, "pick up the thousands of filaments that businesses are creating between themselves."

The result was the invention of the first massive "public memory systems" to record and classify—in rule-bound, certified, and publicly accessible registries, titles, balance sheets, and statements of account—all the relevant knowledge available, whether intangible (stocks, commercial paper, deeds, ledgers, contracts, patents, companies, and promissory notes), or tangible (land, buildings, boats, machines, etc.). Knowing who owned and owed, and fixing that information in public records, made it possible for investors to infer value, take risks, and track results. The final product was a revolutionary form of knowledge: "economic facts."

Over the past 20 years, Americans and Europeans have quietly gone about destroying these facts. The very systems that could have provided markets and governments with the means to understand the global financial crisis—and to prevent another one—are being eroded. Governments have allowed shadow markets to develop and reach a size beyond comprehension. Mortgages have been granted and recorded with such inattention that homeowners and banks often don't know and can't prove who owns their homes. In a few short decades the West undercut 150 years of legal reforms that made the global economy possible.

The results are hardly surprising. In the U.S., trust has broken down between banks and subprime mortgage holders; between foreclosing agents and courts; between banks and their investors—even between banks and other banks. Overall, credit (from the Latin for "trust") continues to flow steadily, but closer examination shows that nongovernment credit has contracted. Private lending has dropped 21 percent since 2007. Outstanding loans to small businesses dropped more than 6 percent over the past year, while lending to large businesses, measured in commercial loans of more than $1 million, fell nearly 9 percent.

The importance of economic facts may not be obvious to Americans. "What does the fish know about the water in which it swims?" asked Albert Einstein. But it's easy to grasp from the perspective of the developing and former communist countries where I live and work. In these countries, most of our assets and relationships are in the informal sector, outside the legal economy. Because they're not recorded in public memory systems, they cannot be written up as facts and are, in effect, invisible. All we have are shadow markets.

Without standardization, the values of assets and relationships are so variable that they can't be used to guarantee credit, to generate mortgages and bundle them into securities, to represent them in shares to raise capital. Nor do they fit the standard slots required to enter global markets. That's why credit crunches and massive unemployment are chronic conditions for most people forced to operate in the informal economy. These are the ones you see protesting in the streets of Arab countries or living in tents surrounding Port-au-Prince. We know only too well that facts don't speak for themselves: They have to be constructed through legal processes and kept transparent. They have to be defended, too.

When then-Treasury Secretary Henry Paulson initiated his Troubled Asset Relief Program (TARP) in September 2008, I assumed the objective was to restore trust in the market by identifying and weeding out the "troubled assets" held by the world's financial institutions. Three weeks later, when I asked American friends why Paulson had switched strategies and was injecting hundreds of billions of dollars into struggling financial institutions, I was told that there were so many idiosyncratic types of paper scattered around the world that no one had any clear idea of how many there were, where they were, how to value them, or who was holding the risk. These securities had slipped outside the recorded memory systems and were no longer easy to connect to the assets from which they had originally been derived. Oh, and their notional value was somewhere between $600 trillion and $700 trillion dollars, 10 times the annual production of the entire world.

Three years later there's still plenty to be concerned about. Governments have worked to enact major financial and regulatory reforms, such as the Wall Street Reform and Consumer Protection Act ushered through Congress in 2010 by former Senator Chris Dodd (D-Conn.) and Representative Barney Frank (D-Mass.). Dodd-Frank has sought to move derivatives into clearinghouses where more data about them can be collected. It's a step in the right direction. But if you believe in the value of public memory and economic facts, the reforms leave a number of problems outstanding.

First, various groups of derivatives end users, such as nonfinancial companies and sovereign wealth funds, are likely to be exempted from the clearing process—from 40 percent of them, according to Craig Pirrong of the University of Houston's Bauer College of Business, to 70 percent, according to Michael Greenberger, a former Commodities Futures Trading Commission director. Second, the information collected would be available only to regulators because certain business data are considered "proprietary." Third, the $700 trillion worth of derivatives that ignited the recession are not covered by Dodd-Frank. Warren Buffett successfully lobbied for their exclusion, saying it would be tantamount to rewriting old contracts and would force healthy derivatives players such as his own Berkshire Hathaway to post collateral on old deals. Fourth, the clearing system is not likely to be fully operational for another 5 to 10 years. Fifth, many clearinghouses do not have the kind of complete information required by traditional public memory systems: incentives for recording that asset owners can't resist; standard classifications to facilitate identifying and governing the assets; universal access to the information; integration or linkages with other recording systems; provisions to protect third parties from negative externalities; identification of all asset holders and interested parties; limited liability provisions to improve accountability.

That's a lot of failure to digest in a single paragraph. So let's look sector by sector at the sorry state of facts in the financial system.

1) Mortgage Bundling. Banks that have tried to foreclose on nonperforming mortgages have discovered that in many cases they can't collect the debts. Why? Because some companies that pooled, packaged, and converted those mortgages into liquid securities had dispensed with the usual procedures to record mortgage owners and passed the property to a shell company called MERS, which pretended to own the mortgages. The intent was to streamline what many real estate experts recognize are outdated, disaggregated, and cumbersome processes. The result, however, is that today, says professor Christopher L. Peterson of the University of Utah, "about 60 percent of the U.S.'s residential mortgages are now recorded in the name of MERS rather than the bank, trust, or company that actually has a meaningful economic interest in the repayment of the debt. For the first time in the nation's history, there is no longer an authoritative, public record of who owns land in each county."

Already the lack of facts is being felt around the U.S.: Courts from Kansas to New York have decided that foreclosures have been improper, and some authorities can't figure out whom to tax. Without facts, credit will continue to be scarce, the value of bonds backed by mortgages will be at best doubtful, the value of houses is likely to slide further, foreclosure backlogs should increase, and banks will see their balance sheets burdened by more nonperforming paper.

2) Default Swaps. The leverage that created so many bad mortgages and the derivatives to help finance them would not have been possible without "credit default swaps" (CDSs)—ingenious derivative instruments that allowed lenders to insure their risks against defaults and pass them on to others. In principle, widening the market should be a good thing. But these risks have slipped outside the public memory systems, making it very difficult to know who ultimately bears the risk and where it is.

Robert Engle, a Nobel laureate who teaches economics at New York University, has said that proposals for reforming CDSs by Western governments are "good as far as they go, but they don't go far enough." European central banker Alexandre Lamfalussy and others have so far been unsuccessful at trying to collect information or even at creating a "risk office" at the Bank for International Settlements (BIS). In the last quarter of 2010, various BIS publications noted that statistics on international debt still had too many gaps and overlaps—and that banks, fearful over their proprietary obligations, were reluctant to provide information.

3) Exemptions. When the recession sent the prices of financial holdings spiraling downward, some banks and financiers were exempted from the U.S.'s long-established "mark-to-market" accounting standards, which force firms to report the value of their assets at current market prices. It's reasonable to establish value other than through market prices, according to proponents, if the market is unusually depressed. But such a privilege creates the ability to destroy facts by hiding losses, increasing the price of assets to levels at which no one will buy. In the U.S., the Financial Accounting Standards Board and the Securities and Exchange Commission are reviewing accounting rules, while Congress has been holding hearings on the subject. Meantime, businesses are left to figure out reality on the basis of connections, influence, and private information. Just like we do in developing and former communist countries.

4) Off-Balance-Sheet Accounting. The modern balance sheet can be traced to Luca Pacioli, the 15th century mathematician and father of accounting. In the 1990s governments began destroying Pacioli's legacy by allowing companies in financial difficulty to pass facts concerning debts from their public balance sheet to a less visible memory system called a special purpose entity (SPE) (or to sweep debt information into the balance sheet's footnotes in words so obtuse that the statements cease being factual). Such "off-balance-sheet accounting" makes companies appear more profitable, despite their debts. By the time Enron closed its doors in 2002, it had created some 3,500 SPEs.

According to Frank Partnoy, a professor of securities law at the University of San Diego and one of the most insightful observers of the financial crisis, "abusive off-balance-sheet accounting" was its major cause. Yes, the Sarbanes-Oxley reforms were an effort to counter such abuses, and principles-based accounting where companies are told what they can do rather than how to do it may be steps in the right direction. But until we get the facts, we won't know what to repair.

5) Government Use of Swaps and Repo Markets. Greece is the most notorious example of a country using derivative-based currency swaps to swell the value of government assets by pushing national debts into the future. Gustavo Piga, a professor of economics at the University of Rome Tor Vergata, revealed this fact-destroying practice: A country issues a debt in one currency—dollars, let's say—at fictional exchange rates that it swaps for a euro debt for a certain period of time. Thus it gets an inflow of money that makes the ledger look positive because the actual debt appears as a swap that has produced income. Governments and banks can also distort facts by getting short-term funds against their assets in the so-called repo market, which, as a result of new rules in the past decade, they don't have to report as loans in their memory systems. This is apparently how Lehman Brothers made it look like it had some $50 billion less in loans outstanding than it really did.

Europeans outlawed interest-rate swaps in 2008, though Piga has pointed out numerous loopholes. And it is hardly promising that Bloomberg News was forced to sue the European Central Bank for refusing to release information on Greece's derivatives transactions. Dodd-Frank is essentially silent on the issue of repo markets. Gary Norton at the Brookings Institution has argued that we still do not have the vaguest idea of the size of the repo market.

6) Rating Agencies. Originally created to get and communicate the facts regarding the trustworthiness of businesses through a ratings scale, ratings agencies were an innovative way to get an abbreviated picture about a given business. But their reputation suffered when highly rated companies barely survived the outbreak of the recession or had to be rescued.

There seems to be more of a consensus about how to reform the ratings system. Dodd-Frank provides for an Office of Credit Ratings, though it has yet to be staffed. Europe, too, has established a new regulating agency, European Securities and Markets Authority, responsible for creating a central data repository to track rating agencies and their performance.

Important, too, is to consider whether overreliance on ratings based on co-variance formulas is a trustworthy substitute for facts. Any reform effort must keep in mind the difference between facts, which can be tested for truth, and opinions, such as ratings, which can't. Facts are not simply about transparency; facts are about empirical truth.

If we can agree that the recession wasn't about bubbles but about the organization of knowledge, we can move on to restoring the systems that allowed the global economy to expand more in the last 60 years than in the previous 2,000.

We are now staring at a legal and political challenge. A legal challenge because American and European governments allowed economic activity to cross the line from the rule-bound system of property rights, where facts can be established, into an anarchic legal space, where arbitrary interests can trump facts and paper swirls out of control. The rule of law is much more than a dull body of norms: It is a huge, thriving information and management system that filters and processes local data until it is transformed into facts organized in a way that allows us to infer if they hang together and make sense.

Mainly, though, it's a political challenge. Politicians must raise the financial crisis to commanding heights, where the entrenched institutional problems of a failing order can be addressed. Markets were never intended to be anarchic: It has always been government's role to police standards, weights and measures, and records, and not condone legalized sleight of hand in the shadows of the informal economy. To understand and repair one of mankind's greatest achievements—the creation of economic facts through public memory—is the stuff of nation-builders.

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