

# THE MYSTERY OF CAPITAL

## Why Capitalism Triumphs in the West and Fails Everywhere Else

By Hernando de Soto



### Chapter 1

#### *The Five Mysteries of Capital*

*The key problem is to find out why that sector of society of the past, which I would not hesitate to call capitalist, should have lived as if in a bell jar, cut off from the rest; why was it not able to expand and conquer the whole of society? ... [Why was it that] a significant rate of capital formation was possible only in certain sectors and not in the whole market economy of the time?*

*-Fernand Braudel, The Wheels of Commerce*

The hour of capitalism's greatest triumph is its hour of crisis. The fall of the Berlin Wall ended more than a century of political competition between capitalism and communism. Capitalism stands alone as the only feasible way to rationally organize a modern economy. At this moment in history, no responsible nation has a choice. As a result, with varying degrees of enthusiasm, Third World and former communist nations have balanced their budgets, cut subsidies, welcomed foreign investment, and dropped their tariff barriers.

Their efforts have been repaid with bitter disappointment. From Russia to Venezuela, the past half-decade has been a time of economic suffering, tumbling incomes, anxiety, and resentment; of "starving, rioting, and looting," in the stinging words of Malaysian prime minister Mahathir Mohamad. In a recent editorial the *New York Times* said, "For much of the world, the marketplace extolled by the West in the afterglow of victory in the Cold War has been supplanted by the cruelty of markets, wariness toward capitalism, and dangers of instability." The triumph of capitalism only in the West could be a recipe for economic and political disaster.

For Americans enjoying both peace and prosperity, it has been all too easy to ignore the

turmoil elsewhere. How can capitalism be in trouble when the Dow Jones Industrial average is climbing higher than Sir Edmund Hillary? Americans look at other nations and see progress, even if it is slow and uneven. Can't you eat a Big Mac in Moscow, rent a video from Blockbuster in Shanghai, and reach the Internet in Caracas?

Even in the United States, however, the foreboding cannot be completely stifled. Americans see Colombia poised on the brink of a major civil war between drug-trafficking guerrillas and repressive militias, an intractable insurgency in the south of Mexico, and an important part of Asia's force-fed economic growth draining away into corruption and chaos. In Latin America sympathy for free markets is dwindling: concretely, support for privatization has dropped from 46 per cent of the population in 1998 to 36 per cent in May 2000. Most ominously of all, in the former communist nations capitalism has been found wanting, and men associated with old regimes stand poised to resume power. Some Americans sense too that one reason for their decade-long boom is that the more precarious the rest of the world looks, the more attractive American stocks and bonds become as a haven for international money.

In the business community of the West, there is a growing concern that the failure of most of the rest of the world to implement capitalism will eventually drive the rich economies into recession. As millions of investors have painfully learned from the evaporation of their emerging market funds, globalization is a two-way street: If the Third World and former communist nations cannot escape the influence of the West, neither can the West disentangle itself from them. Adverse reactions to capitalism have also been growing stronger within rich countries themselves. The rioting in Seattle at the meeting of the World Trade Organization in December 1999 and a few months later at the IMF / World Bank meeting in Washington DC, regardless of the diversity of the grievances, highlighted the anger that spreading capitalism inspires. Many have begun recalling the economic historian Karl Polanyi's warnings that free markets can collide with society and lead to fascism. Japan is struggling through its most prolonged slump since the Great Depression. Western Europeans vote for politicians who promise them a "third way" that rejects what a French best-seller has labeled *L'horreur économique*.

These whispers of alarm, disturbing though they are, have thus far only prompted American and European leaders to repeat to the rest of the world the same wearisome lectures: Stabilize your currencies, hang tough, ignore the food riots, and wait patiently for the foreign investors to return.

Foreign investment is, of course, a very good thing. The more of it, the better. Stable currencies are good, too, as are free trade and transparent banking practices and the privatization of state-owned industries and every other remedy in the Western pharmacopoeia. Yet we continually forget that global capitalism has been tried before. In Latin America, for example, reforms directed at creating capitalist systems have been tried at least four times since independence from Spain in the 1820s. Each time, after the initial euphoria, Latin Americans swung back from capitalist and market economy policies. These remedies are clearly not enough. Indeed, they fall so far short as to be almost irrelevant.

When these remedies fail, Westerners all too often respond not by questioning the adequacy of the remedies but by blaming Third World peoples for their lack of entrepreneurial spirit or market orientation. If they have failed to prosper despite all the excellent advice, it is because something is the matter with them: They missed the Protestant Reformation, or they are crippled by the disabling legacy of colonial Europe, or their IQs

are too low on the Bell Curve. But the suggestion that it is culture that explains the success of such diverse places as Japan, Switzerland, and California, and culture again that explains the relative poverty of such equally diverse places as China, Estonia, and Baja California, is worse than inhumane; it is unconvincing. The disparity of wealth between the West and the rest of the world is far too great to be explained by culture alone. Most people want the fruits of capital-so much so that many, from the children of Sanchez to Khrushchev's son, are flocking to Western nations.

The cities of the Third World and the former communist countries are teeming with entrepreneurs. You cannot walk through a Middle Eastern market, hike up to a Latin American village, or climb into a taxicab in Moscow without someone trying to make a deal with you. The inhabitants of these countries possess talent, enthusiasm, and an astonishing ability to wring a profit out of practically nothing. They can grasp and use modern technology. Otherwise, American businesses would not be struggling to control the unauthorized use of their patents abroad, nor would the U.S. government be striving so desperately to keep modern weapons technology out of the hands of Third World countries. Markets are an ancient and universal tradition: Christ drove the merchants out of the temple two thousand years ago, and Mexicans were taking their products to market long before Columbus reached America.

But if people in countries making the transition to capitalism are not pitiful beggars, are not helplessly trapped in obsolete ways, and are not the uncritical prisoners of dysfunctional cultures, what is it that prevents capitalism from delivering to them the same wealth it has delivered to the West? Why does capitalism thrive only in the West, as if enclosed in a bell jar?

In this book I intend to demonstrate that the major stumbling block that keeps the rest of the world from benefiting from capitalism is its inability to produce capital. Capital is the force that raises the productivity of labor and creates the wealth of nations. It is the lifeblood of the capitalist system, the foundation of progress, and the one thing that the poor countries of the world cannot seem to produce for themselves, no matter how eagerly their people engage in all the other activities that characterize a capitalist economy.

I will also show, with the help of facts and figures that my research team and I have collected, block by block and farm by farm in Asia, Africa, the Middle East, and Latin America, that most of the poor already possess the assets they need to make a success of capitalism. Even in the poorest countries, the poor save. The value of savings among the poor is, in fact, immense-forty times all the foreign aid received throughout the world since 1945. In Egypt, for instance, the wealth that the poor have accumulated is worth fifty-five times as much as the sum of all direct foreign investment ever recorded there, including the Suez Canal and the Aswan Dam. In Haiti, the poorest nation in Latin America, the total assets of the poor are more than one hundred fifty times greater than all the foreign investment received since Haiti's independence from France in 1804. If the United States were to hike its foreign-aid budget to the level recommended by the United Nations-0.7 percent of national income-it would take the richest country on earth more than 150 years to transfer to the world's poor resources equal to those they already possess.

But they hold these resources in defective forms: houses built on land whose ownership rights are not adequately recorded, unincorporated businesses with undefined liability, industries located where financiers and investors cannot see them. Because the rights to these possessions are not adequately documented, these assets cannot readily be turned

into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment.

In the West, by contrast, every parcel of land, every building, every piece of equipment, or store of inventories is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy. Thanks to this representational process, assets can lead an invisible, parallel life alongside their material existence. They can be used as collateral for credit. The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. These assets can also provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (like mortgage-backed bonds) that can then be rediscounted and sold in secondary markets. By this process the West injects life into assets and makes them generate capital.

Third World and former communist nations do not have this representational process. As a result, most of them are undercapitalized, in the same way that a firm is undercapitalized when it issues fewer securities than its income and assets would justify. The enterprises of the poor are very much like corporations that cannot issue shares or bonds to obtain new investment and finance. Without representations, their assets are dead capital.

The poor inhabitants of these nations -the overwhelming majority- do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation. It is the unavailability of these essential representations that explains why people who have adapted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work.

This is the mystery of capital. Solving it requires an understanding of why Westerners, by representing assets with titles, are able to see and draw out capital from them. One of the greatest challenges to the human mind is to comprehend and to gain access to those things we know exist but cannot see. Not everything that is real and useful is tangible and visible. Time, for example, is real, but it can only be efficiently managed when it is represented by a clock or a calendar. Throughout history, human beings have invented representational systems -writing, musical notation, double-entry bookkeeping- to grasp with the mind what human hands could never touch. In the same way, the great practitioners of capitalism, from the creators of integrated title systems and corporate stock to Michael Milken, were able to reveal and extract capital where others saw only junk by devising new ways to represent the invisible potential that is locked up in the assets we accumulate.

At this very moment you are surrounded by waves of Ukrainian, Chinese, and Brazilian television that you cannot see. So, too, are you surrounded by assets that invisibly harbor capital. Just as the waves of Ukrainian television are far too weak for you to sense them directly but can, with the help of a television set, be decoded to be seen and heard, so can capital be extracted and processed from assets. But only the West has the conversion process required to transform the invisible to the visible. It is this disparity that explains why Western nations can create capital and the Third World and former communist nations cannot.

The absence of this process in the poorer regions of the world-where five-sixths of

humanity lives- is not the consequence of some Western monopolistic conspiracy. It is rather that Westerners take this mechanism so completely for granted that they have lost all awareness of its existence. Although it is huge, nobody sees it, including the Americans, Europeans, and Japanese who owe all their wealth to their ability to use it. It is an implicit legal infrastructure hidden deep within their property systems -of which ownership is but the tip of the iceberg. The rest of the iceberg is an intricate man-made process that can transform assets and labor into capital. This process was not created from a blueprint and is not described in a glossy brochure. Its origins are obscure and its significance buried in the economic subconscious of Western capitalist nations.

How could something so important have slipped our minds? It is not uncommon for us to know how to use things without understanding why they work. Sailors used magnetic compasses long before there was a satisfactory theory of magnetism. Animal breeders had a working knowledge of genetics long before Gregor Mendel explained genetic principles. Even as the West prospers from abundant capital, do people really understand the origin of capital? If they don't, there always remains the possibility that the West might damage the source of its own strength. Being clear about the source of capital will also prepare the West to protect itself and the rest of the world as soon as the prosperity of the moment yields to the crisis that is sure to come. Then the question that always arises in international crises will be heard again: Whose money will be used to solve the problem?

So far, Western countries have been happy to take their system for producing capital entirely for granted and to leave its history undocumented. That history must be recovered. This book is an effort to reopen the exploration of the source of capital and thus explain how to correct the economic failures of poor countries. These failures have nothing to do with deficiencies in cultural or genetic heritage. Would anyone suggest "cultural" commonalities between Latin Americans and Russians? Yet in the last decade, ever since both regions began to build capitalism without capital, they have shared the same political, social, and economic problems: glaring inequality, underground economies, pervasive mafias, political instability, capital flight, flagrant disregard for the law. These troubles did not originate in the monasteries of the Orthodox Church or along the pathways of the Incas.

But it is not only former communist and Third World countries that have suffered all of these problems. The same was true of the United States in 1783, when President George Washington complained about "banditti ... skimming and disposing of the cream of the country at the expense of the many." These "banditti" were squatters and small illegal entrepreneurs occupying lands they did not own. For the next one hundred years, such squatters battled for legal rights to their land and miners warred over their claims because ownership laws differed from town to town and camp to camp. Enforcing property rights created such a quagmire of social unrest and antagonism throughout the young United States that the Chief Justice of the Supreme Court, Joseph Story, wondered in 1820 whether lawyers would ever be able to settle them.

Do squatters, bandits, and flagrant disregard of the law sound familiar? Americans and Europeans have been telling the other countries of the world, "You have to be more like us." In fact, they are very much like the United States of a century ago when it too was a Third World country. Western politicians once faced the same dramatic challenges that leaders of the developing and former communist countries are facing today. But their successors have lost contact with the days when the pioneers who opened the American West were undercapitalized because they seldom possessed title to the lands they settled and the goods they owned, when Adam Smith did his shopping in black markets and

English street urchins plucked pennies cast by laughing tourists into the mud banks of the Thames, when Jean-Baptiste Colbert's technocrats executed 16,000 small entrepreneurs whose only crime was manufacturing and importing cotton cloth in violation of France's industrial codes.

That past is many nations' present. The Western nations have so successfully integrated their poor into their economies that they have lost even the memory of how it was done, how the creation of capital began back when, as the American historian Gordon Wood has written, "something momentous was happening in the society and culture that released the aspirations and energies of common people as never before in American history."<sup>1</sup> The "something momentous" was that Americans and Europeans were on the verge of establishing widespread formal property law and inventing the conversion process in that law that allowed them to create capital. This was the moment when the West crossed the demarcation line that led to successful capitalism-when it ceased being a private club and became a popular culture, when George Washington's dreaded "banditti" were transformed into the beloved pioneers that American culture now venerates.

The paradox is as clear as it is unsettling: Capital, the most essential component of Western economic advance, is the one that has received the least attention. Neglect has shrouded it in mystery -in fact, in a series of five mysteries.

### **The Mystery of the Missing Information**

Charitable organizations have so emphasized the miseries and helplessness of the world's poor that no one has properly documented their capacity for accumulating assets. Over the past five years, I and a hundred colleagues from six different nations have closed our books and opened our eyes-and gone out into the streets and countrysides of four continents to count how much the poorest sectors of society have saved. The quantity is enormous. But most of it is dead capital.

### **The Mystery of Capital**

This is the key mystery and the centerpiece of this book. Capital is a subject that has fascinated thinkers for the past three centuries. Marx said that you needed to go beyond physics to touch "the hen that lays the golden eggs"; Adam Smith felt you had to create "a sort of waggon-way through the air" to reach that same hen. But no one has told us where the hen hides. What is capital, how is it produced, and how is it related to money?

### **The Mystery of Political Awareness**

If there is so much dead capital in the world, and in the hands of so many poor people, why haven't governments tried to tap into this potential wealth? Simply because the evidence they needed has only become available in the past forty years as billions of people throughout the world have moved from life organized on a small scale to life on a large scale. This migration to the cities has rapidly divided labor and spawned in poorer countries a huge industrial-commercial revolution-one that, incredibly, has been virtually ignored.

### **The Missing Lessons of U.S. History**

What is going on in the Third World and the former communist countries has happened before, in Europe and North America. Unfortunately, we have been so mesmerized by the

failure of so many nations to make the transition to capitalism that we have forgotten how the successful capitalist nations actually did it. For years I visited technocrats and politicians in advanced nations, from Alaska to Tokyo, but they had no answers. It was a mystery. I finally found the answer in their history books, the most pertinent example being that of U.S. history.

### **The Mystery of Legal Failure: Why Property Law Does Not Work Outside the West**

Since the nineteenth century, nations have been copying the laws of the West to give their citizens the institutional framework to produce wealth. They continue to copy such laws today, and obviously it doesn't work. Most citizens still cannot use the law to convert their savings into capital. Why this is so and what is needed to make the law work remains a mystery.

The solution to each of these mysteries is the subject of a chapter in this book.

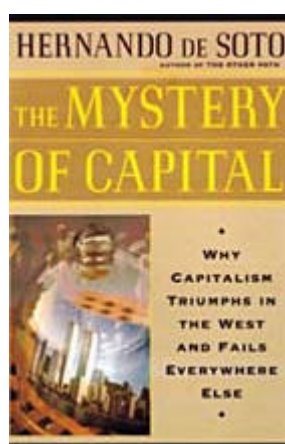
The moment is ripe to solve the problem of why capitalism is triumphant in the West and stalling practically everywhere else. As all plausible alternatives to capitalism have now evaporated, we are finally in a position to study capital dispassionately and carefully.

#### **Notes:**

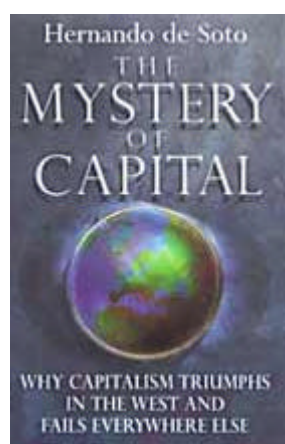
<sup>1</sup> Gordon S. Wood, "Inventing American Capitalism," New York Review of Books (June 9, 1994), p. 49.

Copyright © 2000 Hernando de Soto. All rights reserved.

--From *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, by Hernando de Soto, Hernando de Soto. © September 5, 2000



[amazon.com](http://amazon.com)



[amazon.co.uk](http://amazon.co.uk)

