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As Safe as Housewives

De Soto has calculated that the total value of the real estate occupied by the world's poor amounts to $9.3 trillion.

The problem is that the people in countless shanty towns the world over do not have secure legal title to their homes. And without some kind of legal title, property cannot be used as collateral for a loan.

The result is a fundamental constraint on economic growth, de Soto reasons, because if you can't borrow, you can't raise the capital to start a business. Potential entrepreneurs are thwarted. Capitalist energies are smothered. A large part of the trouble is that it is so bureaucratically difficult to establish legal title to property in places like South America.

De Soto's **solution**: breathing life into this capital. Only with a working system of property rights can the value of a house be properly established by the market; can it easily be bought and sold; can it legally be used as collateral for loans

Quilmes, a sprawling slum on the southern outskirts of Buenos Aires provides a natural experiment to find out if de Soto really has unravelled the 'mystery of capital'.

In 1981, after the restoration of democracy the provincial government expropriated the original owners of the land to give the squatters legal title to their homes.

However, only eight of the thirteen landowners accepted the compensation they were offered. The result was that some of the Quilmes squatters became property owners by paying a nominal sum for leases, which, after ten years, became full deeds of ownership; while others remained as squatters.

Today you can tell the owner-occupied houses from the rest by their better fences and painted walls. As everyone knows, owners generally take better care of properties than tenants do.

There is no doubt that home ownership has changed people's attitudes in Quilmes. According to one recent study, those who have acquired property titles have become significantly more **individualist** and **materialist** in their attitudes than those who are still squatting.

Yet there seems to be a flaw in de Soto’s theory, for owning their homes has not made it significantly easier for people in Quilmes to borrow money. Only 4 per cent have managed to secure a mortgage.

In de Soto's native Peru, too, ownership alone doesn't seem to be enough to resuscitate dead capital. True, after his initial recommendations were accepted by the Peruvian government in 1988, there was a drastic reduction in the time it took to register a property (to just one month) and an even steeper 99 per cent cut in the costs of the transaction.

Yet economic progress of the sort de Soto promised has been disappointingly slow. Out of more than 200,000 Lima households awarded land titles in 1998 and 1999, only around a quarter had secured any kind of loans by 2002.

Remember: **it's not owning property that gives you security; It just gives your creditors security. Real security comes from having a steady income**. For that reason, it may not be necessary for every entrepreneur in the developing world to raise money by mortgaging his house. Or her house. In fact, home ownership may not be the key to wealth generation at all.

Betty Flores is one of Pro Mujer's clients, who taken out a loan to enlarge her coffee stall and it had worked. She is not what would conventionally be through of as a good credit risk. She has modest savings and does not own her own home.

Yet she and thousands of women like her in poor countries around the world are being lent money by institutions like Pro Mujer as part of a revolutionary effort to unleash female enterpreneurial energies. The great revelation of the microfinance movement in countries like Bolivia is that women are actually a better credit risk than men, with or without a house as security for their loans.

The founder of the microfinance movement, the Nobel prize winner **Muhammad Yunus**, came to understand the potential of making small loans to women when studying rural poverty in his native Bangladesh. His mutually owned **Grameen Bank**, founded in the village of Jobra in 1983, has made microloans to nearly seven and a half million borrowers, nearly all of them women who have no collateral. Virtually all the borrowers take out their loans as members of a five-member group *(koota),* which meets on a weekly basis and informally shares responsibility for loan repayments.

Pro Mujer, founded in 1990 by Lynne Patterson and Carmen Velasco, is among the most successful of Grameen Bank's South American imitators. Loans start at around $200 for three months. Most women use the money to buy livestock for their farms or, like Betty, to fund their own micro-businesses, selling anything from tortillas to Tupperware.

There are institutions like Pro Mujer in poor countries all over the world and not only in the developing world. Microfinance can also work in enclaves of poverty in the developed world – like Castlemilk in Glasgow, where a whole network o f lending agencies called credit unions has been set up as an antidote to predatory lending by loan sharks.

Of course, it would be a mistake to assume that microfinance is the holy grail solution to the problem of global poverty, any more than is Hernando de Soto's property rights prescription. Roughly **2/5 of the world's population** is effectively **outside the financial system**, without access to bank accounts, much less credit. But just giving them loans won't necessarily consign poverty to the museum whether or not you ask for collateral. Nor should we forget that some people in the microfinance business are in it to make money, not to end poverty. Some microfinance firms are charging interest rates as high as 80 or even 125 per cent a year on their loans - rates worthy of loan sharks. The justification is that this is the only way to make money, given the cost of administering so many tiny loans.

From Empire to Chimerica

During the Asian Crisis of 1997-8, it was conventional wisdom that **financial crises** were more likely to happen on the periphery of the world economy - in the so-called **emerging markets** (formerly known as less developed countries) of East Asia or Latin America. Yet the biggest threats to the global financial system in this **new century** have come not from the periphery but **from the core**. In the two years after Silicon Valley's dot-com bubble peaked in August 2000, the US stock market fell by almost half. It was not until May 2007 that investors in the Standard & Poor's 500 had recouped their losses. Then, just three months later, a new financial storm blew up, this time in the credit market rather than the stock market.

There was a time when American crises like these would have plunged the rest of the global financial system into recession, if not depression. Yet at the time of writing Asia seems scarcely affected by the credit crunch in the US. Indeed, some analysts like Jim O'Neill say the rest of the world, led by booming China, is 'decoupling' itself from the American economy.

If O'Neill is correct, we are living through one of the most **astonishing shifts** there has ever been in the global balance of financial power and China could overtake the United States in around 2027.

Between 1700 and 1950 there was a 'great divergence' of living standards between East and West. While China may have suffered an absolute decline in per capita income in that period, the societies of the North West - in particular Britain and its colonial offshoots - experienced unprecedented growth thanks, in large part, to the impact of the **industrial revolution.**

What went wrong in China between the 1700s and the 1970s?

One argument is that China missed out on **two major macroeconomic strokes of good luck** that were indispensable to the North- West's eighteenth-century take-off. The first was the conquest of the Americas and particularly the conversion of the islands of the Caribbean into sugar-producing colonies, 'ghost acres' which relieved the pressure on a European agricultural system that might otherwise have suffered from Chinese-style diminishing returns. The second was the proximity of coalfields to locations otherwise well suited for industrial development.

Globalization and Armageddon

It used to be said that emerging markets were the places where they had emergencies. Investing in far-away countries could make you rich but, when things went wrong, it could be a fast track to financial ruin.

Financial history suggests that many of today's emerging markets would be better called re-emerging markets. These days, **the ultimate re-emerging market is China** and this is not the first time that foreign investors have poured money into Chinese securities, dreaming of the vast sums to be made from the world's most populous country.

The **key problem** with overseas investment, then as now, is that it is hard for investors in London or New York to see what a foreign government or an overseas manager is up to when they are an ocean or more away. Moreover, most non-Western countries had, until quite recently, highly unreliable legal systems and differing accounting rules.

In the first era of globalization, the **solution** to this problem was brutally simple but effective: to impose European rule.

William **Jardine** and James Matheson were buccaneering Scotsmen who had set up a trading company in the southern Chinese port of Guangzhou in 1832. One of their best lines of business was importing government produced **opium** from India, but for distinctly non-medicinal purposes. This was a practice that the Emperor Yongzheng had prohibited over a century before, in 1729, because of the high social costs of opium addiction.

The Daoguang Emperor blockaded the Guangzhou opium godowns until the British merchants acceded to his demands. In all, around 20,000 chests of opium valued at 2 million pounds were surrendered. The contents were adulterated to render it unusable and literally thrown in the sea. The Chinese also insisted that henceforth British subjects in Chinese territory should submit to Chinese law.

This was not to Jardine's taste at all. After three meetings with the Foreign Secretary, Viscount Palmerston, Jardine seems to have persuaded him. that a **show of strength** was required, and that 'the want of power of their war junks' would ensure an easy victory for a 'sufficient‵ British force. On 20 February 1840 Palmerston gave the order.

After a ten-month stand off, British marines seized the forts that guarded the mouth of the Pearl River, the waterway between Hong Kong and Guangzhou. Under the Convention of Chuenpi, signed in January 1841, **Hong Kong** became a **British possession**. The Treaty of Nanking confirmed this cession and also gave free rein to the opium trade in five so-called treaty ports: Canton, Amoy, Foochow, Ningbo and Shanghai. According to the principle of extraterritoriality, British subjects could operate in these cities with complete immunity from Chinese law. As Hong Kong flourished as an entrepot, opium soon ceased the company's sole line of bussiness.

Back in London, an investor had myriad foreign investment opportunities open to him. Following the money from London to the rest of the world reveals the full extent of this first financial globalization. Around 45 per cent of British investment went to the United States, Canada and the Antipodes, 20 per cent to Latin America, 16 per cent to Asia, 13 per cent to Africa and *6* per cent to the rest of Europe. If you add together all the British capital raised through issues of securities between 1865 and 1914 , you see that the majority went overseas; less than a third was invested in the United Kingdom itself.

British investors were attracted to foreign markets simply by the prospect of **higher returns** in capital-poor regions. Somewhere between two fifths and half of all this British overseas investment went to British-controlled colonies. A substantial proportion also went to countries like Argentina and Brazil over which Britain exercised considerable informal influence.

Between 1865 and 1914 British investors put at least 74 million pounds into Chinese securities, a tiny proportion of the total 4 billion pounds that they held abroad by 1914 , but a significant sum for impoverished China.

No matter how tightly the British controlled Hong Kong, they could do nothing to prevent China from becoming embroiled first in a war with Japan in 1894-5, then in the Boxer Rebellion of 1900 and finally in the revolution that overthrew the Qing dynasty in 1911 - a revolution partly sparked by widespread Chinese disgust at the extent of foreign domination of their economy. Each of these **political upheavals hit foreign investors** where it hurts them the most: in their wallets. Much as happened in later crises - the Japanese invasion of 1941 or, for that matter, the Chinese takeover in 1997 - investors in Hong Kong saw steep declines in the value of their Chinese bonds and stocks.

The three decades before 1914 were **golden years** for international investors - literally. Communications with foreign markets dramatically improved due to the telegraph, Europe's central banks had nearly all committed themselves to the gold standard by 1908; that meant that they nearly all had to target their gold reserves, raising rates if they experienced a specie outflow. At the very least, this simplified life for investors, by reducing the risk of large exchange rate fluctuations. Higher growth also raised tax revenues.

All these benign economic trends encouraged optimism. To many businessmen it was self-evident that a major war would be catastrophic for the capitalist system. In 1910, the left-leaning British journalist Norman Angell published *The Great Illusion,* in which he argued that a war between the great powers had become an economic impossibility precisely because of 'the delicate interdependence of our credit-built finance`.

Financial markets had initially shrugged off the assassination of the Archduke Franz Ferdinand, in the Bosnian capital Sarajevo on 28 June 1914. Not until 22 July did the financial press express any serious anxiety that the Balkan crisis might escalate into something bigger and more economically threatening.

The first symptom of the crisis was a rise in shipping insurance premiums in the wake of the Austrian ultimatum to Serbia. Bond and stock prices began to slip as prudent investors sought to increase the liquidity of their positions by shifting into cash. European investors were especially quick to start selling their Russian securities, followed by Americans. Exchange rates went haywire as a result of efforts by cross-border creditors to repatriate their money: sterling and the franc surged, while the ruble and dollar slumped. By 30 July panic reigned on most financial markets. Perhaps the most remarkable feature of the crisis of 1914 was the closure of the world's major stock markets for periods of up to five months. The near-universal adoption of the gold standard in the crisis of 1914 it tended to exacerbate the liquidity crisis.

The **war** of 1914 was understood to be a special kind of **emergency**, justifying measures that would have been inconceivable in peacetime, including (as one Conservative peer put it) 'the release of the bankers . . . from all liability`.

Despite the best efforts of the bankers, who indefatigably floated loans for such unpromising purposes as the payment of German reparations, it proved **impossible to restore** the old order of free capital mobility between the wars. Currency crises, defaults, arguments about reparations and war debts and then the onset of the Depression led more and more countries to impose exchange and capital controls as well as protectionist tariffs and other trade restrictions, in a vain bid to preserve national wealth at the expense of international exchange.

Consciously or unconsciously, all governments applied in peacetime the **economic restrictions** that had first been imposed between 1914 and 1918. There may be a lesson here for our time, too. The first era of financial globalization took at least a generation to achieve. But it was blown apart in a matter of days. And it would take more than two generations to repair the damage done by the guns ofAugust 1914.

Economic Hit Men

At **Bretton Woods**, the soon-to-be-victorious Allies met in July 1944 to devise a new financial architecture for the post-war world. In this new order, trade would be progressively liberalized, but restrictions on capital movements would remain in place. Exchange rates would be fixed, as under the gold standard, but now the anchor – the international reserve currency - would be the dollar rather than gold.

When capital sums did flow across national borders, they would go from government to government, like the **Marshall Aid** that helped revive devastated Western Europe between 1948 and 1952. The **two guardian** 'sisters' of this new order were to be established in Washington, DC, the capital of the 'free world': the **International Monetary Fund** and the International Bank for Reconstruction and Development, later (in combination with the International Development Association) known as the **World Bank**. In the words of current World Bank President Robert Zoellick, 'The IMF was supposed to regulate exchange rates. What became the World Bank was supposed to help rebuild countries shattered by the war. Free trade would be revived. But free capital flows were out.'

The decision of the Nixon administration to sever the final link with the gold standard (by ending gold convertibility of the dollar) sounded the death knell for Bretton Woods in 1971. When the Arab-Israeli War and the Arab **oil embargo** struck in 1973, most central banks tended to accommodate the price shock with easier credit, leading to precisely the inflationary crisis that General de Gaulle's adviser Jacques Rueff had feared

The days had gone when investors could confidently expect their governments to send a gunboat when a foreign government misbehaved. Now the role of **financial policing** had to be played by two unarmed bankers, the **International Monetary Fund** and the **World Bank**. Their new watchword became 'conditionality': no reforms, no money. Their preferred mechanism was the structural adjustment programme.

To some critics, however, the World Bank and the IMF were no better than agents of the same old Yankee imperialism. Any loans from the IMF or World Bank, it was claimed, would simply be used to buy American goods from American firms – often arms to keep ruthless dictators or corrupt oligarchies in power.

According to Perkins's book, *The Confessions of an* ***Economic Hit Man,*** two Latin American leaders, Jaime RoldTs Aguilera of Ecuador and Omar Torrijos of Panama, were assassinated in 1981 for opposing what he calls 'that fraternity of corporate, government, and banking heads whose goal is global empire`. There is, admittedly, something about his story that seems a little odd. Ecuador and Panama weren't major customers for the United States. In 1990 they accounted for, respectively, 0.17 per cent and 0.22 per cent of total US exports. Those do not seem like figures worth killing for. As Bob Zoellick puts it, 'The IMF and the World Bank lend money to countries in crisis, not countries that offer huge opportunities to corporate America.`

Nevertheless, the charge of neo-imperialism refuses to go away. According to Nobel prize-winning economist Joseph **Stiglitz**, who was chief economist at the World Bank between 1997 and 2000, the IMF in the 1980s not only 'champion[ed] market supremacy with ideological fervour' but also 'took a rather imperialistic view' of its role. Stiglitz's biggest complaint against the IMF is that it responded the wrong way to the Asian financial crisis of 1997, lending a total of $95 billion to countries in difficulty, but attaching Washington Consensus-style conditions that actually served to **worsen the crisis**. It is a view that has been partially echoed by the economist and columnist Paul Krugman. Yet neither Stiglitz nor Krugman offers a convincing account of how the East Asian crisis might have been better managed on standard Keynesian lines, with currencies being allowed to float and government deficits to rise.

Krugman at least acknowledges that the East Asian financial institutions, which had borrowed short-term in dollars but lent out long-term in local currency, bore much of the responsibility for the crisis. Yet his talk of a return of Depression economics now looks overdone. There never was a Depression in East Asia. After the shock of 1998 all the economies affected returned swiftly to rapid growth - growth so rapid, indeed, that by 2004 some commentators were wondering if the 'two sisters' of Bretton Woods any longer had a role to play as international lenders.

In truth, the 1980s saw the rise of an altogether different kind of **economic hit man**, far more intimidating than those portrayed by Perkins precisely because they never even had to contemplate resorting to violence to achieve their objective. To this new generation, making a hit meant making a billion dollars on a single successful **speculation**.

George Soros made his reputation as an analyst and then head of research at the venerable house of Arnhold & S. Bleichroeder. According to Soros's pet theory of 'reflexivity', financial markets cannot be regarded as perfectly efficient, because prices are reflections of the ignorance and biases, often irrational, of millions of investors. 'Not only do market participants operate with a bias', Soros argues, 'but their bias can also influence the course of events. This may create the impression that markets anticipate future developments accurately, but in fact it is not present expectations that correspond to future events but future events that are shaped by present expectations'.

Originally devised to hedge against market risk with **short positions**, which make money if a security goes down in price, a hedge fund provided the perfect vehicle for Soros to exploit his insights about **reflexive markets**. Soros knew how to make money from **long positions** too, it should be emphasized - that is, from buying assets in the expectation of future prices rises.

In 1992 a trillion dollars being traded on foreign exchange markets every day, versus the Bank's of England meagre hard **currency reserves**. Soros reasoned that the rising costs of German reunification would drive up interest rates and hence the Deutschmark. This would make the Conservative government's policy of shadowing the German currency - formalized when Britain had joined the European Exchange Rate Mechanism (ERM) in 1990 - untenable. As interest rates rose, the British economy would tank. Sooner or later, the government would be forced to withdraw from the ERM and devalue the pound. So sure was Soros that the pound would drop that he ultimately bet $10 billion, more than the entire capital of his fund, on a series of transactions whereby he effectively borrowed sterling in the UK and invested in German currency at the pre-I6 September of 1992 price of around 2.95 Deutschmarks.

In 16 September 1992 Britain announces **sterling's exit from the ERM**. Soros' fund made more than a billion dollars as slumped - ultimately by as much as 20 per cent - allowing Soros to repay the sterling he had borrowed but at the new lower exchange rate and to pocket the difference.

The success of Soros' fund was staggering. If someone had invested $100,000 with Soros when he established his second fund (Double Eagle, the earlier name of Quantum) in 1969 and had reinvested all the dividends, he would have been worth $130 million by 1994, an average annual growth rate of 35 per cent. The essential differences between the old and the new economic hit men were twofold: first, the cold, calculating **absence of loyalty** to any particular country - the dollar and the pound could both be shorted with impunity; second, the sheer scale of the money the new men had to play with.

Yet there were limits to the power of the hedge funds. At one level, Soros and his ilk had proved that the markets were mightier than any government or central bank. But that was not the same as saying that the **hedge funds** could always **command the markets**. Reflexivity, as he himself acknowledges, is a special case; it does not rule the markets every week of the year. What, then, if instincts could somehow be replaced by mathematics? What if you could write an infallible algebraic formula for double-digit returns? On the other side of the world - indeed on the other side of the financial galaxy – it seemed as if that formula had just been discovered.