

# Berlin Wall 1989

## Collapse of Communism - Lesson for Capitalism<sup>1</sup>

Barun Mitra

On November 9, 1989, the Berlin Wall that divided East and West Germany, both physically and ideologically, finally fell. It was a political earthquake, which signaled the end of communism. Communism was characterised by its contempt for private property, by the complete control of the state over the economy, and consequently, by its disregard for price as a signal of scarcity and guide for investment. For over 50 years, price of bread did not change in the erstwhile Soviet Union. Not surprisingly, for much of that time, there was hardly any bread available for increasing number of people. Communism collapsed not because of its ideological baggage, but because of the practical cost of the ideology that tried to make private property redundant.

The 20th anniversary of the fall of the Berlin Wall has become particularly poignant because of the current economic slowdown in much of the rich countries, particularly in that apparent bastion of capitalism, the US. Over the past two years, the foundation of global finance has been shaken, not because of any Marxian foresight, but because of the failure on the part of the capitalist world to appreciate the relationship between property ownership and valuation of that property. The blame for the financial crisis has been ascribed to many—from easy money to human greed, from a lack of government oversight to the lethal financial derivatives.

The fact is that this dramatic chain of events was triggered by the collapse of the housing market in the US in 2007. The housing bubble was supported by public policy aimed at widening home ownership, and facilitated by an elaborate network of financial institutions. These institutions created an ever more elaborate chain of securities that funnelled savings from all over the world into securities that were issued against mortgages taken out by US homeowners.

Originating in single, often modest, loans taken by US families, these mortgages were packaged by banks into so-called MBSs (mortgage-backed securities). First, a retail bank in a small town would bundle its mortgages and transfer them to a regional office. Within days, often hours, the paper would find its way to New York. There, one of only six rating agencies would slice the bundles into layers of securities. Based on statistics of housing loans over the earlier decade, the rating agencies would determine what proportion of the securities should be rated AAA (the safest, with correspondingly low interest rates), 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, to banks and funds. With electronic transfer from a US suburb to a small town in Germany, these securities were virtually '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, and disseminated to it, perhaps by way of London and New York. When the bubble burst, as invariably happens with all asset booms, there were no reliable mechanisms to reassess the risk underlying the securities.

This financial crisis illustrates what happens when the relationship between property and ownership is lost or gets fuzzy. 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, a continuous flow of information about the owners' capacity to

---

<sup>1</sup> This article was first published at <http://www.indefenceofliberty.org/story.aspx?id=2843&pubid=2758>. A version of the article was published in *Financial Express*, titled "Writing on the Wall", on 10 November 2009, <http://www.financialexpress.com/news/writing-on-the-wall/539194/0>

harness the property, and an unencumbered market where the transactions can be undertaken leading to the discovery of the real price of the asset concerned. This price information is critical because it allows capitalisation and ensures the flow of credit, which in turn keeps the wheels of a modern economy turning.

The stock market operates on the basis of continuous disclosure of financial performance of companies, and facility to freely trade the information. So, despite the widely dispersed share ownership, the information regarding the value of the assets, market capitalisation and future prospects gets continuously updated and vetted. In contrast, for the various financial derivatives backed by the mortgages, it was no longer possible to identify the actual assets, no way to assess the financial health of the owners of these properties, and therefore no real market to vet the prices of these papers.

Unfortunately, much of the public discourse has ignored this fundamental dimension of the current economic woes. The housing bubble and the consequent banking crisis provide a glimpse of the tragic consequences of decoupling between property ownership and property valuation.

While world attention is focused on the economic situation in the US and in other developed countries, the situation also underscores the perpetual economic crisis in many developing countries and poor communities, where recognition of property rights and respect for ownership is weak, title documents often non-existent, and access to credit almost impossible. Typically, these are places where informal economic activities dominate.

But the consequences are very similar in both the rich and poor countries—lack of credit. In rich countries, the collapse of real estate prices has shaken the financial structure. With highly leveraged banks and over-extended borrowers, flow of credit has inevitably dried up. On the other hand, the problem in poor countries is not that people don't have assets, but that they are unable to effectively capitalise their assets. With lack of title, grossly inadequate documentation of ownership and relatively high transaction costs have contributed to these assets remaining perpetually uncapitalised. This is what Hernando de Soto, the eminent economist, explained in his path-breaking book, *The Mystery of Capital*.

Developed economies, despite the current turmoil, are strongly rooted to property rights. With a greatly diversified economy, they are likely to come out of the present trough, sooner than later, shaken perhaps, but not stirred! Poor countries, with lack of institutional recognition and respect for property ownership, may not have been shaken as much by the financial crisis. But the vast majority of people will continue to languish in perpetual poverty with little prospect of being able to capitalise their assets, build their creditworthiness and climb the ladder of prosperity.

This partly explains how one small section of India, operating in the formal economy, continues to shine even in these turbulent times, while a vast majority of people operating in the informal sector barely crawls to hold on. Tragically, these poor people, who may not be much shaken, are constantly stirred by the swirling grind of poverty all around them.

Property ownership and respect for property rights laid the foundation for capitalism and opened the door of prosperity in much of the Western world. On the 20th anniversary of the fall of the Berlin Wall, as the global economy grapples with the turmoil and tries to come out of it, it's time to once again renew our appreciation of the significance of private property.



Barun Mitra is the director of Liberty Institute, an independent think tank based in New Delhi.