No Economic Growth Without Clear Property Rights

WASHINGTON – The almost unanimous mission statement of key International Financial Institutions (IFIs) devoted to development, along with national development agencies and their many private and public sector partners is that they are all united in a major effort *"to fight poverty"*, or at least *"reduce poverty"* around the world. Well, may be so. But if this is indeed their goal, they are not focusing on one of the most important issues –may be the most important– that prevents poor countries to get out of poverty.

Not what you think

And it is not what you think. The issue is not insufficient health care services, poor education facilities, or gender inequality. Nor is it insufficient resources devoted to international aid. It is something completely different –and perhaps surprising for both analysts and practitioners.

The issue is property rights, in fact lack of properly defined, universally recognized and enforceable property rights.

Such property rights are clearly defined and codified in modern capitalistic economies. But in most emerging countries their legal status is uncertain, very messy and confused. This creates huge impediments in buying and selling property.

Indeed it is hard and in most cases outright impossible to sell what you do not legally own. Furthermore, all these assets with no legal standing cannot be used as collateral when requesting commercial loans.

The problem is not poverty

Simply stated, in poor countries the main impediment to economic growth and therefore higher standards of living, is not lack of wealth, as in crushing poverty.

The problem is instead that most emerging markets lack the recognized legal frameworks and regulatory arrangements regarding property and its legal status that are common place in most modern countries.

According to economist Hernando de Soto, (*The Mystery of Capital*, published in 2000), the key to understanding under performing economies and therefore continuing poverty is not lack of wealth as an objective impediment.

The problem is that the existing real estate and industrial/commercial ventures assets –and the not insignificant wealth they contain– in most cases are not legally owned by those who control them. Therefore they cannot be mobilized and leveraged by their "owners" in order to spark new investments and thus additional growth. They are therefore "dead assets". And for this reason they cannot be mobilized to obtain financing that would promote significant new economic development.

A big deal

Is this lack of modern property laws and regulations shared by most developing countries really a big deal? Yes, it is.

Let me expand on this. In the U.S. in Europe and elsewhere there are clear laws that provide a legal framework for real estate ownership and related transactions. These laws regulating property rights (with universal applicability within a country) created accessible inventories of all real estate assets. They prescribe how deeds held by property owners should be formulated, what a title to a property is and how it is legally obtained. They also clearly indicate which public agencies are the official repositories of all deeds and titles. As a result, all the real estate existing within any country’s borders is properly accounted for, while all transactions (buying, and selling and more) related to it are a matter of public record.

A uniform legal system regulates property rights

The point here is that in developed countries all records of who owns what are compiled according to one standard formula, this way creating one system that captures all assets and all transactions involving them. These standardized records in turn become accessible public documents that clearly define the nature and boundaries of a property and allow anybody to reliably trace its lawful owners.

Legally owned property can be mobilized

But this is only half the story. The truly important consequence of this uniform legal treatment of property is that, by virtue of having such a system in place, real estate becomes a “live asset” that can be easily bought and sold and rented at market prices.

Most critically, property becomes an asset that can be used as guarantee and collateral for commercial loans and mortgages. Lenders can determine the market value of these assets on the basis of publicly available information regarding their size, locations and other attributes.

Furthermore, owners of large businesses can sell parts of their assets and receive fresh capital by creating corporations that own the assets and therefore can legally issue shares. This way, new shareholders can “own” a fraction of the assets controlled by the corporation without any need to subdivide the assets controlled by it.

None of this in emerging countries

In emerging countries, almost none of this exists. There are some rules regulating property; but they are not uniform and not universally enforceable. They are murky and usually recognized only in a specific locality within the country. Outsiders do not know them and do not understand them.

All this means that property cannot be easily and reliably bought and sold on the basis of market prices. Hard to buy from someone who has no clear legal title on the asset in question. The buyer has no guarantee that henceforth he will indeed be recognized as the lawful owner.

Given all this, most loans that require real estate as collateral, as well as other transactions based on the ability to offer solid guarantees to lenders or business partners, are off-limits to most property "owners", for the simple reason that most people do not "legally" own what they have.

Squatters have no rights

Let me explain. The "owners" do occupy and use property, a building for instance. May be they built it themselves. But they have no legal title to the land on which the building sits, or to the building itself. In most instances they are squatters who built something illegally. Therefore, since they did all this outside any prescribed law, they cannot use the wealth they do have and control –however modest this may be– as collateral that would be accepted by banks in order to get a loan. De Soto correctly calls these assets "dead capital'.

This is critical

Now, how important is all this? very important. Indeed, we all know that commercial credit is the yeast of all modern capitalist economies. It is really hard to think of economic growth without the lubricant and fertilizing power of commercial loans.

But almost all loans that require collateral are beyond the reach of most would-be borrowers in emerging countries. This has the effect of a huge wet blanket on economic growth. How

can a small entrepreneur borrow from a bank to finance its expanding business if he/she cannot offer any collateral? Very simple: they cannot.

Informal sector does not help

Of course, other means to obtain credit may be available within the informal economic sector, (think “loan sharks”), but they are generally extremely onerous in terms of short repayment terms and exorbitant interest rates. Therefore these instruments are in most cases unappealing.

It is clear that these types of “loans” can hardly become the main engine of economic growth serving the purpose of funding promising new enterprises, as is the case in most advanced economies where commercial loans are routinely provided by established banks.

How much “dead capital”?

And how much “dead capital”, (meaning capital that does exist but cannot be leveraged), are we talking about? Well, according to de Soto’s book cited above, an enormous amount:

“By our calculations, [de Soto and his team worked in several countries in order to conduct their research] *the total value of the real estate held but not legally owned by the poor of the Third World and former communist nations is at least $ 9.3 trillion”.*

“This is a number worth pondering: $ 9.3 trillion is about twice as much as the total circulating U.S. money supply….It is more than twenty times the total direct foreign investment into all Third World and former communist countries in the ten years after 1989, forty-six times as the World Bank loans of the past three decades, and ninety-three times as much as all development assistance from all advanced countries to the Third World in the same period”.

(NOTE: Data cited in de Soto's book goes up to the year 2000. Since then the picture may have shifted somewhat. But there has been no dramatic transformation, because in most developing countries property is still held mostly without proper legal title. Therefore, it still cannot be used as collateral for commercial loans and/or any other form of financing).

These are truly amazingly large figures. Yes, poor countries are poor. But not as poor as we would generally think. The problem is that whatever wealth most individuals hold in these countries, it cannot be used as a legally recognized asset; and therefore it cannot be leveraged. This is a major impediment to growth.

Working hard is not enough

It should be stressed that this impediment originating from lack of legal status of so much property has nothing to do with how much or how hard people work in these countries. In poor countries many people do work hard, and they do acquire assets.

The problem is all about the failure to create a modern property laws system that would allow citizens in developing countries to gain legal title to what they own, this way transforming large amounts of *"dead capital"* into *"live capital".*

Priority one

In the light of de Soto's remarkable findings, a legal/regulatory/administrative effort leading to clear and enforceable property rights should be priority one for both governments and donors who want to enhance economic growth in developing countries.

You want to eliminate poverty? Well, begin with breathing real life into (now anemic) commercial lending backed by real estate as collateral.

And this starts with creating a rational and transparent property rights legislation and system that will allow business people to **a)** gain title to what they own, and **b)** be able to borrow in order to grow their enterprises, offering their now *"live assets"* as acceptable collateral.

Oil Prices Will Go Down But U.S. Shale Will Survive

WASHINGTON – After the oil production cuts recently announced first by OPEC and then non OPEC oil producers, oil prices rallied. This is because supply cuts must mean tighter markets and therefore higher prices. Well, looking at what most energy sector analysts say, this idea of a sustained oil rally is a dream that will soon end. And this is because there are too many exemptions to these announced cuts, too many special cases and too many opportunities to cheat, since rather modest total production cuts are to be spread thinly among many producers.

Oil prices will fall again

Who is going to check about full compliance? Bottom line, expect oil prices to lose altitude again, as soon as hard data about production among OPEC and non OPEC countries will become known, probably towards the end of January. Keeping all this into account, while West Texas Intermediate, WTI, closed at about $ 53 on January 5, it is hard to believe that it will stay at that relatively high level for much longer.

What will happen to the U.S. shale sector?

That said, the really interesting question, assuming persistent low crude prices, is whether the U.S. shale oil industry will be able to withstand another prolonged price squeeze.

If recent history is good guidance, I would say: yes, it will. Surprising everybody, the American oil shale sector, until a few years ago deemed to be profitable only assuming oil would stay at or above $ 60 per barrel, managed to survive, when oil beginning in 2014 went down to $50, $ 40, and even $ 30 per barrel.

Of course, the success record is quite uneven within a sector characterized by so many diverse players that differ in terms of size, profitability of their reserves and financial conditions. Many shale energy company, especially those carrying quite a bit of debt, just could not make it. They went bankrupt. Others were bought by stronger competitors.

U.S. shale oil sector made up of diverse players

In truth, there is no such thing as a homogeneous U.S. shale oil sector. There are many energy companies operating in different states. Each one is different. And the chances to survive or thrive in a tough market environment because of low oil prices depend on many factors unevenly spread. Indeed, while examining companies, analysts have to take into account the specific geology that will affect production techniques and oil recovery levels and related costs, the company’s management skills, the amount of debt each company carries, the ability to apply in a timely manner state of the art new technologies, and a lot more.

Still, even taking to account that some companies are strong and some very weak, with many more in between, it is fair to say that the sector as a whole proved to be surprisingly resilient, given the low profit margins in a depressed oil price market.

Sustained production

Yes, the total U.S. rig count went down, dramatically, following the 2014 price collapse. But overall production, with some ups and downs, did not go down that much. The shale oil sector proved to be quite flexible.

While large conventional operations cannot be brought on line, closed and restarted at will, the shale sector is far more flexible. And this means that shale operators do not need to bet on a 5 year window of high prices that will guarantee profits in order to start operations.

They can quickly respond to price fluctuations, producing more when prices are high; while shutting down production when prices drop below their break even point. Look, obviously it is not just like flipping a light switch. But you get the idea. Shale is nimble.

How much flexibility and resilience?

So, flexibility and resilience define the American shale oil sector. But here is the question. Is it possible for U.S. shale to become ever more productive and nimble? Or, at some point, no matter how much they try to cut costs, the energy companies hit a profitability wall?

While we know that the shale plays in the Permian basin in Texas can stay in business even with oil at $ 40 or even $ 30 per barrel, what about all the other reserves in Oklahoma, North Dakota and other states? If we assume prices going down to $ 40 or even $ 30 per barrel for an extended period of time, how many shale companies, many of them operating in far less favorable locations, have a realistic chance to survive, let alone be profitable? Can new fracking technologies perform more miracles, or has the sector become as productive as it can get?

How long can Saudi Arabia endure the adverse impact of lower oil revenue?

The honest answer is that we do not know. That said, we also do not know how long oil prices will stay this low. Indeed, we do not know how long Saudi Arabia, the world's biggest producer and OPEC's *de facto* leader, can endure the economic and fiscal impact of low prices without resorting to much steeper cuts in order to jack up prices and therefore state revenues.

We all know that Saudi Arabia's oil industry will be profitable even with oil at $ 30 per barrel, because Saudi extraction costs are very low. But the problem is that the Saudi Government depends on high oil prices to finance practically everything.

While the Monarchy is trying to change things, right now the Saudi State needs to lubricate with cash infusions a rent based society in which hardly any Saudi citizen is engaged in truly productive activities.

Low oil prices hurt

Which is to say that low oil prices hurt different producers in different ways. OPEC now has tried to drive prices up by announcing relatively modest production cuts to be spread among various producers. Some non OPEC countries indicated that they would also participate, with the shared objective of jacking up prices.

Based on what know, this time the trick probably will not work, because too many producers are saying one thing about cuts and then planning to do the opposite (keep production levels high, or in some cases, ramp up production).

When will Saudi Arabia announce serious cuts?

But at some point Saudi Arabia will start running out of cash;

and so it will have to cut its oil production in order to drive prices up. This would help the Saudi state immensely in its effort to stabilize its finances. However, any Saudi move aimed at supporting oil prices would also help the marginal U.S. shale producers. Some of them are hanging tight, hoping for better days to come.

In other words, who will give up first? Will the U.S. shale sector be eventually defeated by prolonged low oil prices? Or will Saudi Arabia have to swallow the bitter pill and cut production (therefore giving up some of its market share) in a far more significant way in order to drive prices up, with full knowledge that this will help U.S. shale companies?

Bet on Yankee ingenuity

All in all, when it comes to endurance and resilience in adverse market conditions, I would still bet on Yankee ingenuity. The American shale oil industry surprised the world by inventing and then deploying hydraulic fracturing (fracking) and horizontal drilling on a large scale, this way bringing on line millions of barrels of oil that was deemed to be unrecoverable. And then they delivered an even bigger surprise when they managed to make the entire sector much more productive and efficient in record time, when faced with a sudden crude oil price collapse.

None of this could be done, everybody said. And the shale oil people did it. May be they will keep doing it, surprising all analysts once again.