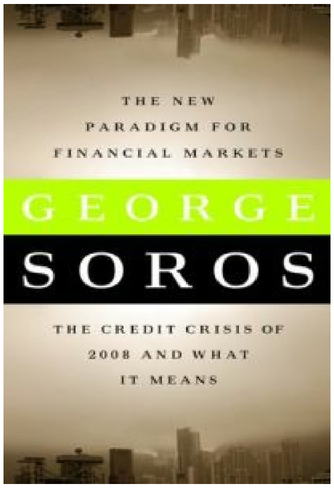

Book The New Paradigm for Financial Markets

The Credit Crisis of 2008 and What It Means

George Soros
Public Affairs, 2008
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Recommendation

Legendary financier George Soros is worried. The financial markets face the worst credit crisis since the Depression and their existing paradigm needs to be replaced. The new paradigm Soros recommends is based on what he calls the "theory of reflexivity." This book-length essay provides a crash course in the billionaire investor's philosophy and view of financial markets, the origins and consequences of the current credit crunch, the boom-bust model and the behavior of market participants. Soros intersperses his market analysis with enough personal details from his early life and career to keep the book lively. He is also quite vocal in his political beliefs; Democrats will probably appreciate the case he makes against President George W. Bush's administration and its policies. One weakness of the book, other than its repetitiveness as Soros explains his theory, is that he relies heavily on technical and financial jargon, which makes it tough to penetrate and may prove a barrier to some readers. Ironically, he seems to be fully aware of this shortcoming when he writes that readers may find one of his particularly theoretical chapters to be "somewhat repetitive and hard-going." Nevertheless, his warm personal voice and the depth of his financial experience, which spans more than half a century, is hard to match. Thus, *BooksInShort* notes that this book has much to offer executives, investors, and students of financial markets and theory.

Take-Aways

- The current paradigm for financial markets says that they tend toward equilibrium and are self-regulatory.
- This is false and misleading; a new paradigm is necessary to explain how financial markets actually work.
- The proposed new paradigm, the "theory of reflexivity," says misconceptions and misinterpretations have played a key role in shaping the course of history.
- Reflexivity refers to the disparity between one's views and reality.
- The theory of reflexivity runs counter to classical economic theory, which assumes that perfect knowledge exists.
- Market participants' perceptions are inherently biased and, thus, mistaken.
- Their imperfect understanding of reality affects market prices.
- The global financial system is in crisis because it is based on erroneous premises.
- The current financial crisis began when the Internet bubble burst in 2000.
- This crisis, the worst since the 1930s, is a result of a "superboom" that has lasted more than a quarter of a century.

Summary

The Global Financial Crisis

The present financial crisis, the worst since the 1930s, is a result of a "superboom" that has lasted more than a quarter of a century. The global financial system got into this kind of trouble largely because it is based on a faulty, “false and misleading” paradigm, which holds that markets tend toward equilibrium. Market participants widely accept the incorrect concepts of perfect competition and the possibility of perfect knowledge, leading them to hold biased perceptions that affect prices and their underlying fundamentals.

> “The theory of reflexivity offers a genuine alternative to the currently prevailing paradigm. If the theory of reflexivity is valid, the belief that financial markets tend towards equilibrium is false, and vice versa.”

The markets need a new paradigm that focuses on the relationship between thinking and reality. This new paradigm must recognize that misinterpretations play a key role in history. Market participants should seriously consider the “theory of reflexivity,” which says that markets do not reach the equilibrium that is said to exist. Instead, it acknowledges that misconceptions are inevitable and that a true understanding of the markets should reflect the impact of misunderstandings.

“Setting the Stage”

The current financial crisis is more than a housing bubble and is greater than the previous crises the markets have witnessed. It began in August 2007, when central banks in Europe, the U.S. and Japan stepped in to provide liquidity to their respective banking systems. The crisis had its roots in 2000, when the Internet bubble burst, followed by the terrorist attacks of September 11, 2001. The U.S. Federal Reserve Bank (Fed) responded by lowering rates and permitting cheap money, which ultimately resulted in the emergence of a housing bubble. Mortgage lenders encouraged business growth, and new construction boomed along with the value of existing properties. In the early 2000s, the subprime mortgage market grew and hedge funds became a market phenomenon. The current crisis has ballooned beyond housing to include many market segments, especially those that are involved with new synthetic financial instruments.

“The Core Idea”

Market participants’ understanding of the world, their “cognitive function,” is inherently imperfect. Therefore, the connection between what they understand and their attempts to change the actuality of their financial situation, breeds an element of uncertainty. Although investors would like to affect reality by using their “manipulative function,” they face a “reflexive situation,” meaning that their views and reality do not match. The problem is that the theory of rational expectations does not appropriately address how financial markets function. Contrary to the existing paradigm, the markets are not self-correcting and do not tend toward equilibrium. Consequently, this paradigm must be replaced. It is mistaken to compare the structure of social events to the structure of natural phenomena. Reflexivity attempts to demonstrate the relationship between thinking and reality, and is limited to social phenomena. This is preferable to the current paradigm, where participants base their decisions on biased views and interpretations of reality, and not on knowledge.

“Autobiography of a Failed Philosopher”

In 1947, author George Soros immigrated to England from communist-held Hungary, having survived Nazi occupation. As a lonely outsider in London, he ran out of money and vowed never again to reach bottom. At the London School of Economics, he was introduced to the work of philosopher Karl Popper, who was a great influence on him. In agreement with Popper, Soros created the reflexivity concept that market participants operate with imperfect understanding. His theory is not scientific, but it rebuts common misconceptions and provides a basis for understanding financial events involving people, who are innately fallible. Since his theory does not yield firm predictions, Soros does not know to what extent his financial success is a result of his philosophy.

> “The distinguishing feature of reflexivity is that it introduces an element of uncertainty into the participants’ thinking and an element of indeterminacy into the situation in which they participate.”

Reflexivity comes into play where the truth of a statement depends on the statement itself. For example, if you say, “It is raining,” it doesn't make a difference whether you say so or not, it will still be raining. In contrast, if you tell someone, “You are my enemy,” the fact that you said so may make it true.

“The Theory of Reflexivity”

Reflexivity highlights a distortion in the way philosophers and scientists view the world. They focus primarily on cognitive function, and thus make mistakes. Reflexivity introduces the idea that market participants’ thinking is inherently uncertain and that all “cultures are built on fertile fallacies,” which can result in adverse consequences. While Popper asserts that market participants might be wrong, Soros goes further by saying that they are “bound” to be wrong. This concept, which he calls the “postulate of radical fallibility,” says that misconceptions exist and play a role in history. Radical fallibility and fertile fallacies are pivotal to Soros’s beliefs. He says they should replace the concepts of general equilibrium and rational expectations, which do not correspond to reality.

“Reflexivity in Financial Markets”

The markets provide a good venue for demonstrating that reflexive developments exist and are historically important. The role of expectation is very clear in financial markets, however, Soros has successfully used a fund-management model that demonstrates that the concept of rational expectations does not make sense. Because market participants always act with imperfect knowledge, they fall victim to unintended consequences, such as incorrectly valued market prices.

> “In financial markets, where expectations play an important role, the contention that markets tend towards equilibrium does not correspond to reality.”

In the 1960s, Soros achieved early success as a hedge-fund manager by taking advantage of the conglomerate boom. That boom was based on a typical old-paradigm misconception: the prevailing belief that companies should be valued based on the growth of their reported earnings per share, no matter how they achieved those earnings. When stock prices fell, they revealed the stark difference between expectations and reality. All boom-bust processes are based on some misunderstanding or misconception. After a slow start, a gradual acceleration follows the boom phase; then a moment of truth occurs, followed with a period of twilight before the catastrophic crash. The positive news is that periodic crises in the financial system have led to regulatory reforms.

“The ‘Super-Bubble’ Hypothesis”

The current crisis is unlike the periodic crises that have affected different parts of the financial system since the 1980s. This crisis – including both the housing bubble and the "longer-term super-bubble" – has led the whole financial system to the verge of collapse.The U.S. housing bubble grew after the technology bubble burst in 2000 and the Fed lowered rates. The housing bubble likewise followed Soros's model of boom-bust. The misconception inherent in that bubble was that loose lending standards would not hurt the value of collateral. Until 2007, speculative demand sustained the bubble. The super-bubble, which is more complex than the housing bubble, reflects the added impact of sophisticated forms of credit creation. The super-bubble is the result of extreme dependence on "market fundamentalism," the current paradigm. That adds to the case for abandoning this paradigm, which is responsible for the present market turmoil.

"Autobiography of a Successful Speculator"

Soros has 55 years of financial market experience. When he began his career in London in 1954, credit cards did not exist, governments tightly regulated banks and markets, and the U.S. dominated the global financial system. He moved to the U.S. in 1956 and became part of the first generation of hedge-fund managers. In 2001, long since a billionaire, he converted his hedge fund into an "endowment fund" to manage his foundations' assets. In the interim, he worked through a lot of financial turmoil. The first oil crisis, in 1973, gave birth to the Eurodollar market. International lending grew rapidly from 1973 to 1979. As the world faced an inflationary boom in the 1970s, the U.S. suffered stagflation– rising inflation combined with high unemployment rates. The international banking crisis began in the 1980s. For example, by 1982, Mexico was on the brink of defaulting on its debt. The International Monetary Fund worked to bail out Mexico and other debtor countries. After the IMF and other actors contained the crisis, regulators gave U.S. banks more freedom to create money and lifted other restrictions.

> "I adopt as my working hypothesis that we are bound to be wrong. I call this the postulate of radical fallibility."

In the current crisis, regulatory authorities are to blame for not being able to calculate the risk of new, sophisticated financial instruments. They should not have permitted the institutions they supervised to take on risks that they, the regulators, could not calculate. The Fed is likewise to blame for failing to regulate the mortgage industry. Banking and investment banking are now likely to undergo further regulatory changes.

Soros's 2008 Predictions

The consequences of the economic crisis will be more severe and long-lasting than the results of previous financial crises, and economic growth will not resume as quickly. President George W. Bush is unlikely to take much action regarding the housing crisis during the waning months of his administration. The current account deficit in the U.S. has peaked and this, too, will hurt the American economy. Financial institutions have yet to unwind fully. The Federal Reserve and the Bush administration are unlikely to do whatever is necessary to avoid recession; in fact, the commodity boom and the vulnerable dollar may prevent them from being able to act. Thus, the U.S. will hit a recession some time in 2008, but it remains to be seen whether or not the global slowdown will become a global recession.

> "The policies pursued by the Bush administration have impaired the political dominance of the United States, and now a financial crisis has endangered the international financial system and reduced the willingness of the rest of the world to hold dollars."

The financial crisis and a U.S. recession may not significantly hinder dynamic growth developments in China, India and some oil-producing nations. China will emerge unscathed from the current financial crisis and from any consequent recession, though its longer-term outlook is uncertain. China's current growth bubble could lead to a crisis in several years. Elsewhere, offshore natural gas should enable India to become energy self-sufficient in the next few years, so expect its economy to perform well. Some Middle-Eastern oil-producing nations also will become sources of economic strength. Developing countries will outperform developed ones.

Policy Recommendations

Soros's already finds that the financial system is being disrupted more severely than he had anticipated as widening credit spreads cause mortgage rates to rise. The housing market has yet to find a bottom and the dollar is falling to new lows. Monetary authorities need to avoid the formation of any other asset bubbles.

> "This is the first time since the Great Depression that the international financial system has come close to a genuine meltdown. That is the crucial difference between this financial crisis and previous ones."

The new reflexivity paradigm recognizes the fallibility of financial markets and regulatory authorities, which have failed to exercise control. They now must regulate credit creation, re-establish control over excess leverage, learn to understand recent innovations and prohibit practices they do not fully comprehend. The public must hold them responsible if they allow an institution to get so out of control that it needs rescuing. The government should create a clearing-house for credit default swaps as one means of helping to resolve the credit crisis.

> "I foresee a period of political and financial instability, hopefully to be followed by the emergence of a new world order."

As for the housing crisis, regulators must take necessary measures to limit the collapse in the prices of homes. Avoiding foreclosure should be a primary objective of policy measures. U.S. Representative Barney Frank is correct in proposing modification of the bankruptcy law to empower bankruptcy judges to rewrite loan terms for principal residences. Frank also proposes enabling the Federal Housing Administration (FHA) to offer guarantees to assist subprime borrowers in refinancing into more affordable mortgages. In New York City and Maryland, Soros's foundation is working to keep borrowers in their homes.

About the Author

Billionaire financier, investor, philanthropist and former hedge-fund manager **George Soros** chairs Soros Fund Management. He founded a global network of foundations that support open societies. His best-selling books include *The Bubble of American Supremacy*, *Underwriting Democracy* and *The Age of Fallibility*.