BOOK REVIEW

THE NEW PARADIGM FOR FINANCIAL MARKETS

George Soros

Reviewed by

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> "People want to know what lies ahead. I cannot tell them because I do not know. What I want to tell them is something different. I want to explain the human condition".
>
> *George Soros*

Plato spoke of philosophers becoming kings, but what can one make of a philosopher ruling the financial markets with the bountiful blessing of the tenth muse? George Soros is that rare human being; the knight of darkness, who broke the sterling pound in 1992 after impoverishing the Bank of England of one-third of its foreign reserves for an astounding reward of $ 1 billion, is, in intellectual accomplishment and indeed in self-conception, an earnest philosopher. Hence perhaps, for all the laser-like sharpness of the financial analyst's mind, the shades of Hamlet in the words quoted above.

In viewing the current global financial crisis, George Soros in this latest book argues that the hoary paradigm that markets tend towards equilibrium and deviations from it are but random is both wrong and misleading. Out it must go, he says, and to take its place we would need to explore a new conceptual framework on how markets really work. Soros for one would place at the centre of such framework his own theory of reflexivity.

He elaborates reflexivity by distinguishing two human functions attached to thinking and reality: cognitive, which seeks to understand the world and manipulative, which seeks to change it. Mostly these functions operate simultaneously and when they do, the functions interfere with each other in a two-way feedback loop, producing 'reflexivity'. The term reflexivity, unlike its signification in logic, is used by Soros to describe a two-way connection

between the participants' thinking and the situation in which they participate. When we are part of the world that we seek to understand, we cannot base our decisions on full knowledge and what we lack in knowledge we have to make up with guesswork based on experience, instinct and so forth – biased views and misconceptions thus generated tend to introduce an element of uncertainty into what happens. Both our cognitive and manipulative functions are exposed to such uncertainty. In financial markets, all this means that both market participants and financial authorities in charge of policy and regulation invariably act on the basis of an imperfect understanding of the situation in which they are participating. Disaster can ensue because "element of uncertainty inherent in the two-way reflective connection between the cognitive and manipulative functions cannot be eliminated". But we would certainly be better off with that awareness.

Soros makes the interesting point that economic theory has gone to great lengths to exclude reflexibility from its purview. This is because when it comes to finance, reflexibility would militate against producing theories to explain and predict the behaviour of financial markets a la natural sciences. Woe betide anyone who lets that happen! But in Soros' own case, as a student of economic theory he could not bring himself to accept (natural) scientific pretensions on the part of economics. The theory of perfect competition, for example, was in direct conflict with what he had learnt in philosophy under Karl Popper – that perfect competition assumed perfect knowledge and that assumption was in direct conflict with what he had learnt about human understanding being inherently imperfect. So, out perfect competition! Out also, the world of mathematical models describing a putative market equilibrium. "I was more interested in the real world than in mathematical models and that is what led me to the concept of reflexivity", he says.

Although, to the disgust of economists, the theory of reflexivity does not yield determinate results comparable to Newtonian physics, Soros finds in it the merit of identifying an element of indeterminacy inherent in situations where participants operate on the basis of imperfect understanding. More important, the proof of the pudding being in eating, the theory served Soros well enough when he became a market participant.

Soros' thinking, in his own words, has 'radical fallibility' and the idea of 'fertile fallacies' as its hallmarks. The former emphasizes the divergence between reality and the participant's perception of reality; it happens because participants are part of the reality they seek to understand and ergo, a part cannot fully comprehend the whole. Moreover, the mind is

driven to process information by using various techniques like metaphors and generalizations which not only can distort information but take on an existence of their own, further complicating both reality and understanding. The idea of fertile fallacies denotes that our understanding of reality is inherently imperfect, but as we acquire knowledge and it proves useful in understanding we are liable to overexploit it and extend it to areas where it no longer applies.

Soros elaborates the two concepts with some rigour, briefly tracing them through the philosophies of Enlightenment, logistical positivism and Karl Popper's doctrine, but the exegesis is not without practical insights. He gives short shrifts to the postmodern approach to reality as a collection of often conflicting narratives and failing to give sufficient weight to the objective aspect of reality. And he is spot-on when he goes on say for good measure that he has gained a healthy respect for the objective aspect of reality both by having lived under Nazi and Communist regimes and by speculating in the financial markets!

> "The only experience that teaches you more respect for an external reality that is beyond your control than losing money in the financial markets is death – and death is not an actual experience during one's lifetime"
>
> – Geroge Soros.

He also makes the diverting comment that he sees a direct connection between the post-modern idiom and the Bush administration's ideology; the administration not merely recognized that the truth could be manipulated (that the invasion of Iraq was for the war on terror), but that it promoted the manipulation of truth as a superior approach, with disastrous consequences.

In the core portion of the book Soros sets out his basic arguments; that financial markets provide an excellent laboratory to demonstrate the working of reflexivity, that financial markets need to be interpreted as a somewhat unpredictable historical process rather than one determined by timeless valid laws and that the subprime interlude is liable to force the pace of change to a new approach since it is reflexive processes that are currently unfolding themselves in the financial markets.

According to him, financial markets are always wrong in the sense that they operate with a prevailing bias, but normally they tend to correct their own excesses. Occasionally,

market prices can also influence the fundamentals that they are supposed to reflect, hence the illusion that markets manage to be always right. The change in the fundamentals may then reinforce the biased expectations in an initially self-reinforcing but eventually self-defeating process. When such boom-bust sequences occur, they can assume a large scale as in the Great Depression and as in what is happening now.

The belief that markets tend towards equilibrium, argues Soros, has given rise to policies which seek to give financial markets free rein – that is market fundamentalism and is no better than Marxist dogma because, as theories, what they both invoke does not stand up to the test of reality. On the other hand, not only does the theory of reflexivity provide a better explanation of how financial markets function but it is also less conducive to manipulation of reality than the currently prevailing scientific theories because it avoids making excessive claims about its ability to predict and explain social phenomena.

Financial markets, says Sorors, do not necessarily tend towards equilibrium; left free, they are liable to go to extremes of euphoria and despair, thus in December 1996, Alan Greenspan famously pronounced himself against "irrational exuberance" of the U.S. stock market, but hardly did anything beyond that. Subsequently he also erred in keeping federal funds at 1 per cent longer than necessary – thereby paving the way for the real estate bubble.

Soros' analysis of the US housing bubble brings out the fact that the lowering of the federal funds rate to 1% from 2001 to 2004 enabled Americans to add more household mortgage debt in the last six years than in the prior life of the mortgage market. The bubble started slowly, lasted for several years and did not reverse immediately when interest rates started rising because of speculative demand, aggressive lending practices and ever more sophisticated ways of securitizing mortgages. Superimposed on the housing bubble is Soros hypothesis of a super-bubble, originating all the way back in the laissez faire of the 1980s under the Reagan administration when authorities began losing control of financial markets; the boom-bust sequence of this evolution has now finally reached its inflexion. The super-bubble, according to Soros, contains three major trends, each containing at least one defect: first, the long-term trend towards ever increasing credit expansion, the second the globalization of financial markets (serving the objectives of market fundamentalism so well) and three, the accelerating pace of financial innovations. Some symbiotic relationships formed part of this denouement: between the US which was happy to consume more than

it produced and China and other Asian exporters on the reverse mode; between banks and their customers, especially hedge funds and private equity funds and indeed, between mortgage lenders and borrowers. "Subprime crisis was merely the trigger than released the unwinding of the super-bubble".

While Soros feels that the super-bubble hypothesis can be useful for the possibility it offers to create a comprehensive financial history of post world war II period, his point of departure is that it is the belief that markets tend towards equilibrium that is directly responsible for the current turmoil. It encouraged the regulators to abandon their responsibility and rely on the market mechanism to correct its own excesses. "The idea that prices, although they may take random walks, tend to revert to the mean served as the guiding principle for the synthetic financial instruments and investment practices which are currently unraveling".

Soros maintains that the theory of reflexivity with its basic premise that all human constructs, including markets, are fallible can explain the current financial crisis better than the prevailing paradigm, much as it cannot offer generalizations in the mould of natural science. His theory can explain events with greater clarity than it can predict the future, but how far his new paradigm can be developed remains to be seen. "There is just so much that one person can do on his own. Others need to get engaged", he says with unconscious irony.

A critique of the theory of financial markets from an eminent practioner of the métier of finance who has lived through the different stages of the evolution of the global financial system – that is the strong point of this book. While having a Midas touch in profiting by the rules of the global financial markets, Soros has always been consistent in his philosophical musings on the system. And for those who look beyond the complex mathematical models to enlightenment on the waywardness of financial markets as manifested in the doings of Lehman Brothers, rating agencies and the like, the book offers some interesting answers.

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