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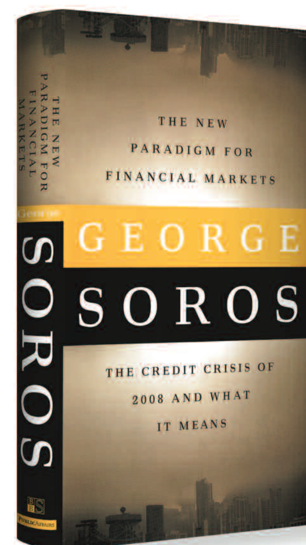

by George Soros

The New Paradigm for Financial Markets

The Credit Crisis of 2008 and What It Means

THE SUMMARY IN BRIEF

"This is the worst crisis since the Great Depression," writes George Soros of the scale of financial distress spreading across financial centers around the world.

In the midst of the most serious financial upheaval in decades, legendary financier George Soros explores the origins of the crisis and its implications for the future. Soros, whose breadth of experience in financial markets is unrivaled, places the current crisis in the context of decades of study of how individuals and institutions handle the boom-and-bust cycles and dominate global economic activity. The prevailing paradigm for financial markets — that markets tend toward equilibrium and deviations from it are random — is both false and misleading, he argues, and only by exploring a new conceptual framework for how markets really work can we avoid disaster and economic ruin.

Combining practical insight with philosophical depth, Soros makes an invaluable contribution to our understanding of the great credit crisis and its implications for our nation and the global economy.

IN THIS SUMMARY, YOU WILL LEARN:

- How the financial crisis is wreaking havoc on the financial system and threatens to engulf the economy.
- Why the concepts of reflexivity and fallibility make an important contribution to our understanding of financial markets.
- Why reflexivity is best demonstrated and studied in the financial markets.
- How the theory of reflexivity applies to the unfolding financial crisis.
- Why the United States needs to gain a better understanding of the situation in which it finds itself today.

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THE COMPLETE SUMMARY: **THE NEW PARADIGM FOR FINANCIAL MARKETS**

by George Soros

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Introduction

We are in the midst of the worst financial crisis since the 1930s. In some ways it resembles other crises that have occurred in the last 20 years, but there is a profound difference: The current crisis marks the end of an era of credit expansion based on the dollar as the international reserve currency. Other periodic crises were part of a larger boom-bust process; the current crisis is the culmination of a super-boom that has lasted for more than 25 years.

To understand what is going on we need a new paradigm. The currently prevailing paradigm, namely that financial markets tend toward equilibrium, is both false and misleading; our current troubles can be largely attributed to the fact that the international financial system has been developed on the basis of that paradigm.

A New Paradigm

The new paradigm proposed here is not confined to the financial markets. It deals with the relationship between thinking and reality, and it claims that misconceptions and misinterpretations play a major role in shaping the course of history.

Market participants cannot base their decisions on knowledge alone, and their biased perceptions have ways of influencing not only market prices but also the fundamentals that those prices are supposed to reflect. The participants' thinking plays a dual role. On the one hand, they seek to understand their situation: the cognitive function. On the other hand, they try to change the situation: the participating or manipulative function. The two functions work in opposite directions and, under certain circumstances, they can interfere with each other. This interference can be called "reflexivity."

Here's how the theory of reflexivity applies to the unfolding financial crisis. Contrary to classical economic theory, which assumes perfect knowledge, neither market participants nor the monetary and fiscal authorities can base their decisions purely on knowledge. Their misjudgments and misconceptions affect market prices, and, more important, market prices affect the so-called fundamentals that they are supposed to reflect.

Bubbles and Super-Bubbles

Market prices do not deviate from a theoretical equilibrium in a random manner, as the current paradigm holds. Participants' and regulators' views never correspond to the actual state of affairs; that is to say, markets never reach the equilibrium postulated by economic theory. There is a two-way reflexive connection between perception and reality, which can give rise to initially self-reinforcing but eventually self-defeating boom-bust processes, or bubbles.

Every bubble consists of a trend and a misconception that interact in a reflexive manner. There has been a bubble in the U.S. housing market, but the current crisis is not merely the bursting of the housing bubble. It is bigger than the periodic financial crises we have experienced in our lifetime. All those crises are part of a super-bubble — a long-term reflexive process that has evolved over the last 25 years or so. It consists of a prevailing trend (credit expansion) and a prevailing misconception (market fundamentalism, which holds that markets should be given free rein).

Previous crises served as successful tests, which reinforced the prevailing trend and the prevailing misconception. The current crisis constitutes the turning point at which both the trend and the misconception have become unsustainable.

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Setting the Stage

The outbreak of the current financial crisis can be officially fixed at August 2007. That was when the central banks had to intervene to provide liquidity to the banking system. As the BBC reported:

• On Aug. 6, American Home Mortgage, one of the largest U.S. independent home loan providers, filed for bankruptcy after laying off the majority of its staff. The company said it was a victim of the slump in the U.S. housing market that had caught out many subprime borrowers and lenders.

• On Aug. 9, short-term credit markets froze up after a large French bank, BNP Paribas, suspended three of its investment funds worth 2 billion euros, citing problems in the U.S. subprime mortgage sector.

• On Aug. 16, Countrywide Financial, the largest U.S. mortgage originator, drew down its entire $11.5 billion credit line. Australian mortgage lender Rams also admitted liquidity problems.

Origins

The crisis was slow in coming, but it could have been anticipated several years in advance. It had its origins in the bursting of the Internet bubble in late 2000. The Fed responded by cutting the federal funds rate from 6.5 percent to 3.5 percent within the space of just a few months. Then came the terrorist attack of Sept. 11, 2001. To counteract the disruption of the economy, the Fed continued to lower rates — all the way down to 1 percent by July 2003, the lowest rate in half a century, where it stayed for a full year. For 31 consecutive months the base inflation-adjusted short-term interest rate was negative.

Cheap money engendered a housing bubble, an explosion of leveraged buyouts and other excesses. When money is free, the rational lender will keep lending until there is no one else to lend to.

On June 15, 2007, Bear Stearns announced that two large mortgage hedge funds were having trouble meeting margin calls. Investors' equity of $1.5 billion was mostly wiped out.

Rattled Markets

The failure of the two Bear Stearns mortgage hedge funds in June badly rattled the markets, but U.S. Federal Reserve chairman Ben Bernanke and other senior officials reassured the public that the subprime problem was an isolated phenomenon.

It was only at the beginning of August that financial markets really took fright. It came as a shock when Bear Stearns filed for bankruptcy protection for two hedge funds exposed to subprime loans and stopped clients from withdrawing cash from a third fund. Bear Stearns had tried to save these entities by providing $3.2 billion of additional funding.

Once the crisis erupted, financial markets unraveled with remarkable rapidity. Everything that could go wrong did. A surprisingly large number of weaknesses were revealed in a remarkably short period of time.

Exposure

The current crisis has spread from one segment of the market to others, particularly those that employ newly created structured and synthetic instruments. Both the exposure and the capital base of the major financial institutions have been brought into question, and the uncertainties are likely to remain unresolved for an extended period of time. This is impeding the normal functioning of the financial system and is liable to have far-reaching consequences for the real economy.

PART ONE: PERSPECTIVE

The Core Idea

Social events have a different structure from natural phenomena. In natural phenomena there is a causal chain that links one set of facts directly with the next. In human affairs the course of events is more complicated. Not only facts are involved but also the participants' views, and the interplay between them enters into the causal chain. There is a two-way connection between the facts and opinions prevailing at any moment in time: On the one hand participants seek to understand the situation (which includes both facts and opinions); on the other, they seek to influence the situation (which again includes both facts and opinions).

The interplay between the cognitive and manipulative functions intrudes into the causal chain so that the chain does not lead directly from one set of facts to the next but reflects and affects the participants' views. Since those views do not correspond to the facts, they introduce an element of uncertainty into the course of events that is absent from natural phenomena. That element of uncertainty affects both the facts and the participants' views.

Uncertainty

The element of uncertainty inherent in social events can be explained by relying on the correspondence theory of truth (the truth corresponds to the facts) and the concept of reflexivity. Reflexivity has been used in logic to refer to a relation that an object has to itself. Here it is used to

describe a two-way connection between the participants' thinking and the situation in which they participate.

Misinterpretations of reality and other kinds of misconceptions play a much bigger role in determining the course of events than is generally recognized. That is the main new insight that the theory of reflexivity has to offer. The current financial crisis serves as a persuasive example.

Autobiography of a Failed Philosopher

The concepts of reflexivity and fallibility make an important contribution to our understanding, not because they are something novel or original by themselves, but because they can be used to identify and refute widespread and influential misconceptions. One of those misconceptions is the Enlightenment fallacy, which assumes that the purpose of reason is to produce knowledge. It is a fallacy because it ignores the manipulative function.

The financial crisis is a vivid demonstration of how much damage misconceptions can cause. 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 toward equilibrium is false, and vice versa.

The Theory of Reflexivity

People are participants, not just observers, and the knowledge they can acquire is not sufficient to guide them in their actions. They cannot base their decisions on knowledge alone. That is the condition described by the word "fallibility."

Fallibility

Without fallibility there would be no reflexivity — if people could base their decisions on knowledge, the element of uncertainty that characterizes reflexive situations would be removed — but fallibility is not confined to reflexive situations. In other words, fallibility is a more comprehensive condition, and reflexivity is a special case.

People's understanding is inherently imperfect because they are part of reality and a part cannot fully comprehend the whole. Our understanding is imperfect, meaning that it is incomplete and, in ways that cannot be precisely defined, distorted. The human brain cannot grasp reality directly but only through the information it derives from it.

Financial Markets

Reflexivity is best demonstrated and studied in the financial markets because financial markets are supposed to be governed by scientific laws. In other areas the science is less well developed. Even in the financial markets, demonstrably reflexive processes occur only intermittently.

On a day-by-day basis markets seem to follow certain statistical rules, but occasionally those rules are broken. We may therefore distinguish between humdrum, everyday events that are statistically predictable, and reflexive processes that are not. The latter are of great significance because they alter the course of history.

Reflexivity distinguishes only two functions: the cognitive and the manipulative. It pinpoints a distortion in the way philosophers and scientists tend to look at the world. Their primary concern is the cognitive function: Insofar as the manipulative function interferes with the proper functioning of cognition, they are inclined to ignore it or to deliberately eliminate it from consideration.

The Human Uncertainty Principle

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.

The uncertainty associated with reflexivity affects not only the participants but also the social scientists who seek to establish universally valid laws governing human behavior. This additional element of uncertainty may be described as the human uncertainty principle, and it complicates the task of the social sciences.

The postulate of radical fallibility emphasizes the divergence between reality and the participants' perception of reality, and it focuses attention on misconceptions as a causal factor in history. This leads to a particular interpretation of history that can be illuminating. The present moment is such a time. The current financial crisis can be directly attributed to a false interpretation of how financial markets function.

Reflexivity in Financial Markets

The financial markets offer an excellent laboratory because most of the price and other data are public and quantified. The main advantage of financial markets as a laboratory is that the theory of reflexivity is in direct contradiction of a theory that is still widely accepted, namely, the belief that financial markets tend toward equilibrium. If equilibrium theory is correct, reflexivity cannot exist. By the same token if the theory of reflexivity is correct, equilibrium theory is invalid.

The New Paradigm

The new paradigm differs from the old one. By applying the postulate of radical fallibility to financial markets,

one can assert that, instead of being always right, financial markets are always wrong. Markets have the ability, however, both to correct themselves and occasionally to make their mistakes come true by a reflexive process of self-validation. That is how they can appear to be always right. To be specific, financial markets cannot predict economic downturns accurately, but they can cause them.

Participants act on the basis of imperfect understanding. They base their decisions on incomplete, biased and misconceived interpretations of reality, not on knowledge, and the outcomes are liable to diverge from expectations. The divergence provides useful feedback on the basis of which they can adjust their behavior. Such a process is unlikely to produce satisfactory results all the time.

Equilibrium

Indeed, markets move away from a theoretical equilibrium almost as often as they move toward it, and they can get caught up in initially self-reinforcing but eventually self-defeating processes. Bubbles often lead to financial crises. Crises, in turn, lead to the regulation of financial markets. That is how the financial system has evolved — periodic crises leading to regulatory reforms.

In the absence of regulatory authorities, financial markets would be bound to break down, but in reality breakdowns rarely occur because markets operate under constant supervision, and even if the authorities tend to be sluggish in normal times, they become alert in an emergency — at least in democracies.

Interplay Between Participants and Regulators

Most of the reflexive processes involve an interplay between market participants and regulators. To understand that interplay it is important to remember that the regulators are just as fallible as are the participants. Changes in the regulatory environment place every crisis into a unique historical context. That alone is sufficient to justify the claim that the behavior of markets is best regarded as a historical process.

Market fundamentalists blame market failures on the fallibility of the regulators, and they are half right: Both markets and regulators are fallible. Where market fundamentalists are totally wrong is in claiming that regulations ought to be abolished on account of their fallibility.

The fact that regulators are fallible does not prove that markets are perfect. It merely justifies re-examining and improving the regulatory environment.

So-Called Fundamentals

When do the reflexive connections that are endemic in financial markets turn into self-reinforcing, historically significant processes which affect not only prices in the financial markets but also the so-called fundamentals that those prices are supposed to reflect? That is the question that a theory of reflexivity has to answer if it is to be of any value.

Based on theoretical arguments and empirical evidence, one hypothesis is that *there has to be both some form of credit or leverage and some kind of misconception or misinterpretation involved for a boom-bust process to develop*. The main insight this conceptual framework has to offer is that misconceptions play a significant role in the making of history. This message is particularly relevant for understanding what is happening in the financial markets at the present moment in history.

Caution and Leverage

One of the major differences between the new paradigm and the old one is that the new one takes a more cautionary approach to the use of leverage. The theory of reflexivity recognizes the uncertainties associated with the fallibility of both regulators and market participants. The prevailing paradigm acknowledges only known risks and fails to allow for the consequences of its own deficiencies and misconceptions. This is what lies at the root of the current turmoil.

PART TWO: THE CURRENT CRISIS AND BEYOND

The Super-Bubble Hypothesis

Superimposed on the U.S. housing bubble there is a much larger boom-bust sequence that has finally reached its inflection, or crossover, point. The super-bubble is more complex than the housing bubble.

Boom-bust processes arise out of a reflexive interaction between a prevailing trend and a prevailing misconception. The prevailing trend in the super-bubble is the same as in the housing bubble — ever more sophisticated methods of credit creation — but the misconception is different. It consists of an excessive reliance on the market mechanism.

Long-Term Trends

The super-bubble combines three major trends, each containing at least one defect.

First is the long-term trend toward ever-increasing credit expansion as indicated by rising loan-to-value ratios in housing and consumer loans, and rising volume of credit to gross national product ratios. This trend is

the result of the countercyclical policies developed in response to the Great Depression. Every time the banking system is endangered, or a recession looms, the financial authorities intervene, bailing out the endangered institutions and stimulating the economy. Their intervention introduces an asymmetric incentive for credit expansion, also known as the moral hazard.

The second trend is the globalization of financial markets, and the third is the progressive removal of financial regulations and the accelerating pace of financial innovations.

Globalization Asymmetry

Globalization also has an asymmetric structure. It favors the United States and other developed countries at the center of the financial system and penalizes the less-developed economies at the periphery. The disparity between the center and the periphery is not widely recognized, but it has played an important role in the development of the super-bubble. And both deregulation and many of the recent innovations were based on the false assumption that markets tend toward equilibrium and deviations are random.

The super-bubble ties together the three trends and the three defects. The first trend can be traced back to the 1930s, but the second and third became firmly established only in the 1980s. So one can date the inception of the super-bubble to the 1980s, because that is when market fundamentalism became the guiding principle of the international financial system.

Housing Bubble

Synthetic financial instruments, risk calculations and proprietary trading models were built on the theory that markets tend toward equilibrium and deviations are random. These innovations took past experience as their starting point, with suitable allowances for deviation and emerging new trends, but they failed to recognize the impact that they themselves made. Households became increasingly dependent on the double-digit appreciation in house prices. The savings rate dropped below zero, and households withdrew equity by refinancing their mortgages at an ever-increasing rate.

Mortgage equity withdrawals reached nearly a trillion dollars in 2006. When house prices stopped rising, these trends had to moderate and eventually reverse. Households found themselves overexposed and overindebted. Eventually, consumption had to fall. The bust is following the classic boom-bust pattern, but, in addition, it has also set in motion a flight from the dollar and an unwinding of the other excesses introduced into the financial system by recent innovations. That is how the housing bubble and the super-bubble are interconnected.

The current crisis constitutes the inflection or crossover point not only in the housing bubble but also in the long-term super-bubble. The subprime crisis was merely the trigger that released the unwinding of the super-bubble.

Market Fundamentalism

President Ronald Reagan called it the magic of the marketplace. Financier George Soros calls it market fundamentalism. It became the dominant creed in 1980 when Reagan became president in the United States and Margaret Thatcher was elected prime minister in the United Kingdom, although its antecedents go back much further.

Reflexivity

The boom-bust pattern is merely a convincing example of reflexivity. It is convincing because it describes market behavior that is in direct contradiction to the prevailing paradigm, which holds that markets tend toward equilibrium.

The prevailing paradigm cannot explain what is happening; the theory of reflexivity can. The case for abandoning the prevailing paradigm is even stronger: The belief that markets tend toward equilibrium 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 that are currently unraveling.

History

According to the new paradigm, events in financial markets are best interpreted as a form of history. The past is uniquely determined; the future is uncertain. Consequently it is easier to explain how the present position has been reached than it is to predict where it will lead.

History, although it is uniquely determined, is so overcrowded that it would be incomprehensible unless the processes and singular events involved were reduced to manageable numbers. That is where the super-bubble hypothesis can help to select the events and developments that deserve consideration.

Autobiography of a Successful Speculator

The technology bubble burst in 2000. Then came the terrorist attack of Sept. 11, 2001. To prevent a recession, the Fed lowered the federal funds rate to 1 percent and kept it there until June 2002. That engendered the housing bubble, in which financial innovations played a major role. With the spreading of risks, more risks could be taken.

Unfortunately, the risks were passed on from those who were supposed to know them to others who were less familiar with them. What is worse, the newly invented methods and instruments were so sophisticated that the regulatory authorities lost the ability to calculate the risk involved. They came to depend on the risk control methods developed by the institutions themselves.

Risk

The various synthetic mortgage securities were based on the assumption that the value of houses in the United States taken as a whole never declines; individual regions may fluctuate, but the market as a whole is stable. That is what made securities spreading the risk over various regions seem more secure than individual mortgages. That assumption ignored the possibility of a nationwide housing bubble of the magnitude that actually occurred.

The regulatory authorities knew that their intervention engendered a moral hazard. They paid lip service to the moral hazard, but when the chips were down they came to the rescue of institutions that were too big to fail. They knew that their intervention introduced asymmetric incentives that favored ever-increasing credit expansion, yet they were so carried away by the prevailing market fundamentalist mood and their own success that they came to believe that markets can self-regulate. That is how credit expansion came to reach unsustainable levels.

Abuses and Excesses

The authorities consistently ignored or underestimated the abuses and excesses in the mortgage industry and the effect on the real economy. That is how the Federal Reserve fell so far behind the curve. The Federal Reserve had the legal authority to regulate the mortgage industry, which it failed to exercise.

The current crisis is incomparably more complicated than the international banking crisis of the 1980s because the mortgages have been sliced up, repackaged and resold, and voluntary cooperation among unknown participants is difficult if not impossible to arrange. Arrangements to provide relief to people who face a sudden jump in interest payments as their teaser rates expire in the next 18 months will have only very limited effect.

Mortgage service companies are overwhelmed and have no financial incentive to arrange for voluntary adjustments. There are some 2.3 million people in that category, many of whom have been duped by unscrupulous lenders. Altogether, the housing crisis will have far-reaching social consequences.

The Soros Outlook for 2008

The theory of reflexivity does not offer any firm predictions. It does help, however, to formulate some conjectures on what the future may hold in store:

1. A 60-year period of credit expansion based on the United States exploiting its position at the center of the global financial system and its control over the international reserve currency has come to an end. The current financial crisis will have more severe and longer-lasting consequences than similar crises in the past. All of this is bound to affect the U.S. economy negatively.

2. One can expect some longer-lasting changes in the character of banking and investment banking. These have been growth industries since 1972, launching ever more sophisticated new products and enjoying ever looser regulation. Regulators will try to regain control over the activities of the industry they are supposed to supervise. How far they go will depend on the severity of the damage. If taxpayers' money is used, Congress will get involved.

3. There are no grounds, however, for predicting a prolonged period of credit contraction or economic decline in the world as a whole because there are countervailing forces at work. China, India and some oil-producing countries are experiencing dynamic developments that may not be significantly disrupted by the financial crisis and a recession in the United States. The U.S. recession itself will be cushioned by an improvement in the current account deficit.

4. The United States during the Bush administration failed to exercise proper political leadership. As a result the United States has suffered a precipitous decline in its power and influence in the world. The invasion of Iraq has much to do with the rise in the price of oil and the unwillingness of the rest of the world to hold dollars. A recession in the United States and the resilience of China, India and the oil-producing countries will reinforce the decline in the power and influence of the United States. The decline of the dollar as the generally accepted reserve currency will have far-reaching political consequences and will raise the specter of a breakdown in the prevailing world order. Generally

speaking, we are liable to pass through a period of great uncertainty and destruction of financial wealth before a new world order emerges.

Guesswork

These insights are too general to be of much use in practical decision making. To be more specific one needs to engage in guesswork.

Some Policy Recommendations

Clearly an unleashed and unhinged financial industry is wreaking havoc with the economy. It needs to be reined in. Credit creation by its nature is a reflexive process. It needs to be regulated in order to prevent excesses. We must remember, however, that regulators are not only human but also bureaucratic. Going overboard with regulations could severely impede economic activity. Markets should be given the greatest possible scope compatible with maintaining economic stability.

The regulators need to gain a better understanding of the recent innovations, and they ought not to allow practices that they do not fully understand. There are systemic risks that need to be managed by the regulatory authorities. To be able to do so they need to have adequate information.

Money Supply and Credit Creation

The most important lesson to be learned from the current crisis is that the monetary authorities have to be concerned not only with controlling the money supply but also with credit creation. Monetary authorities have to be concerned not only with wage inflation but also with avoiding asset bubbles. The monetary authorities have to monitor and take into account not only money supply but also credit conditions.

One specific measure that could help relieve the credit crisis is the establishment of a clearinghouse or exchange for credit default swaps. There is much to be gained by establishing a clearinghouse or exchange with a sound capital structure and strict margin requirements to which all existing and future contracts would have to be submitted.

Avoiding foreclosures ought to be the primary focus of additional policy measures. Both systemic and individualized approaches are needed.

Conclusion

Eventually, the U.S. government will have to use taxpayers' money to arrest the decline in house prices. Until it does, the decline will be self-reinforcing, with people walking away from homes in which they have negative equity and more and more financial institutions becoming insolvent, thus reinforcing both the recession and flight from the dollar.

The Bush administration and most economic forecasters do not understand that markets can be self-reinforcing on the downside as well as the upside. They are waiting for the housing market to find a bottom on its own, but it is further away than you think.

The Bush administration resists using taxpayers' money because of its market fundamentalist ideology and its reluctance to yield power to Congress. It has left the conduct of policy largely to the Federal Reserve. This has put too much of a burden on an institution designed to deal with liquidity, not solvency, problems. With the Bear Stearns rescue operation and the latest-term security lending facility, the Fed has put its own balance sheet at risk. Current policies are inadequate. It will be difficult to stay ahead of the curve.

Insufficient Knowledge

We have to make decisions without having sufficient knowledge at our disposal. Our decisions have great impact. We can do a lot of good or a lot of harm. But we have not learned how to govern ourselves. As a consequence, we live in great uncertainty and grave danger. We need to gain a better understanding of the situation in which we find ourselves. It is difficult to accept uncertainty. It is tempting to try to escape it by kidding ourselves and each other, but that is liable to land us in greater difficulty.

Let this not be the conclusion but the beginning of a concerted effort at better understanding the human condition. Given our increased control over the forces of nature, how can we govern ourselves better? How is the new paradigm for financial markets to be reconciled with the old one? How should financial markets be regulated? How can the international financial system be reformed? How can we deal with global warming and nuclear proliferation? How can we bring about a better world order? These are the questions for which we have to find answers.

RECOMMENDED READING LIST

If you liked *The New Paradigm for Financial Markets*, you'll also like:

1. ***Blueprint to a Billion*** **by David Thomson.** What does it take to become a billion-dollar corporation? This summary has the answer.
2. ***Competing for the Future*** **by Gary Hamel and C.K. Prahalad.** Create a successful future by transforming your company into a nimble organization.
3. ***Thriving on Chaos*** **by Tom Peters.** This summary points the way toward success for corporations struggling to maintain or regain markets.