The New Paradigm for Financial Markets:
The Credit Crisis of 2008 and What It Means
Author: George Soros
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About the Author:
George Soros is one of the most notable and controversial financiers of our time. He is the chairman of Soros Fund Management and the founder of numerous philanthropic foundations dedicated to the goal of promoting free and open societies. He is also the author of many bestsellers including The Bubble of American Supremacy, Underwriting Democracy, and The Age of Fallibility.

General Overview:
In the midst of the most serious financial upheaval since the Great Depression, George Soros explores the origins of the crisis and its implications for the future. He places the current crisis in the context of decades of study of how individuals and institutions handle the boom and bust cycles that now dominate global economic activity.

In The New Paradigm for Financial Markets, Soros combines practical insight with philosophical depth as he aims to help readers understand the great credit crisis and its implications for the United States and the world.

* Please Note: This CapitolReader.com summary does not offer judgment or opinion on the book’s content. The ideas, viewpoints and arguments are presented just as the book’s author has intended.
**Introduction**

We are facing the most challenging financial crisis since the Great Depression. There are some ways in which the current credit meltdown resembles the numerous market crises we have experienced over the last several decades, but this one is unique in that it marks the end of an era. A cycle of credit expansion tied to the preeminence of the dollar as the world’s reserve currency has run its course. We are, in short, at the tail end of a super boom that has lasted more than a quarter century.

The prevailing school of thought holds that markets tend towards equilibrium. This paradigm is false and it cannot explain the current market meltdown. Reliance on the prevailing paradigm – call it free market fundamentalism – is a key reason our financial system has been brought to the brink of collapse.

We need a new financial paradigm. In particular, the concept of *reflexivity*, which involves the relationship between thinking and reality, can help show how misunderstandings and misconceptions play a major role in shaping economic and political history. To put it simply, the free market is not an infallibly self-correcting mechanism where unfettered competition engenders perfect knowledge that leads inexorably towards equilibrium. Rather, market participants entertain biases and misconceptions that inevitably influence not just market prices, but also economic fundamentals. Economists have not embraced this view, largely because it threatens to undermine the myth that economics is a purely objective science. However, the theory of reflexivity does a far better job of explaining what happens in financial markets than the alternative of classical economic theory.

The current financial crisis can be used to illustrate both the weakness of classical economic theory and the strength of the theory of reflexivity. It is clear from the housing bubble and the credit crisis, for instance, that many of the central tenets of *laissez-faire* economics (Reaganomics in contemporary parlance) are false. Market participants do not converge towards perfect knowledge, nor is the absence of regulation desirable. Instead, misperceptions and misunderstanding can generate self-reinforcing processes that eventually become self-defeating processes. In other words, biases lead to speculative bubbles, which inevitably go bust.

The concept of reflexivity inevitably puts the cognitive factor back into economics. It implies that we can never have perfect knowledge about the world because we are *part* of the world we are studying. Concomitantly, the idea that economics can be a purely objective science is revealed as a chimera. Our biases – the notion that real estate prices can only go up (or the idea that perpetual lending will not affect housing prices) – impact market fundamentals. This two-way street, between perception and reality, is at the heart of financial crises.
We need to “confront reality instead of trying to escape it.” In many respects, classical economic theory was a system of assumptions and idealizations that could not stand the test of reality. The theory of reflexivity does not represent, by any means, an ultimate or final truth. It is, however, a powerful tool for shedding light on our present economic predicament, and even human nature.

The Current Crisis
The current financial crisis began in August of 2007. At this point, serious problems in the U.S. housing market and the subprime mortgage industry became evident. Short-term credit markets froze up and, as a result, central banks intervened to provide liquidity.

In truth, the present credit crunch was a long time in the making. The housing bubble was an outgrowth of the Internet bubble of 2000. After all, following the crash of tech stocks, the Fed cut interest rates from 6.5% to 3.5% in only a matter of months. Then came the terror attacks of 9/11, which saw the Fed slash rates all the way to 1%. In fact, for nearly three years, the inflation-adjusted short-term interest rate was negative.

“Cheap money engendered a housing bubble, an explosion of leveraged buyouts, and other excesses.” This is hardly surprising; when money is essentially free, lenders have an incentive to keep lending until there is no one left to lend to. In fact, mortgage lenders lowered their lending standards to generate their fees while repackaging mortgages that they passed off to third-party institutional investors. As a result, banks had little interest in verifying the credit worthiness of their customers.

In a five-year period (2000-2005), housing prices appreciated by an unprecedented 50%. According to one estimate, about half of America’s GDP growth in 2005 was housing-related. Meanwhile, rising home prices led consumers to treat their homes as ATMs. In 2006, for instance, Americans withdrew more than $9 trillion from their home equity. Needless to say, real estate speculation, “ninja” loans (no job, no income, no assets), and securitization (forms of insurance designed to eliminate risk) helped feed the housing frenzy. In the end, however, these practices fostered an increasing reliance on leverage, which only served to make the inevitable landing harder.

Mortgage lenders passed off their riskiest loans by repackaging them into securities known as collateralized debt obligations (CDOs). These are mortgages that have been sliced and diced into a series of tiers (known as tranches) with varying yields tailored to institutional customers with varying risk tolerances. The complexity of these instruments, however, meant that few customers, rating agencies, or regulators appreciated the risks involved. Indeed, the fact that banks could reap fees while passing off risk “encouraged lax and deceptive business practices.” The entire subprime industry, in particular, was permeated by predatory lending and fraudulent activities.
Hedge funds participated in the market for “synthetic” securities by offering insurance for CDOs and even more complex financial instruments. The extreme leverage used by hedge funds, combined with the difficulty of valuing insurance to cover the so-called “toxic waste” (the riskiest loans), was a recipe for disaster. The fallout began when several of the largest subprime lenders – New Century Financial and Accredited Home Lenders – were forced to reveal billions of dollars in bad loans. This led to the announcement by investment giant Bear Stearns that two of its hedge funds could not meet margin calls. At the same time, Merrill Lynch and Citigroup took huge write-downs on their CDOs. Fed Chairman Ben Bernanke assured the public that the subprime problem was contained, but the evidence indicates the threats to the real economy are more far-reaching and systemic than officials acknowledge.

“The real expansion was stimulated by credit expansion.” Therefore, it is unreasonable to expect that the economy will not be adversely affected by a credit contraction. Put simply, the present crisis is a reflection of the fact that both market participants and financial officials harbored serious misconceptions about the way financial markets work. We need a new conceptual framework to better understand how financial markets function, how they can go wrong, and how we can correct and manage problems that arise.

**The Core Idea: Reflexivity**

We are part of the world we are seeking to understand. This fact makes our understanding inherently imperfect. Two factors constitute our involvement in the world: 1) the cognitive function and 2) the manipulative function. The cognitive function is simply our efforts to understand the world. While the manipulative function, on the other hand, consists of our efforts to shape the world to our advantage. These two functions do not operate, as many economists presuppose, in isolation from one another.

Since both functions can operate simultaneously they sometimes interfere with each other. For instance, our desires and expectations (that go hand in hand with our efforts to manipulate the world) can cloud the cognitive function, which seeks knowledge and facts about the phenomena in the world. “The role that intentions and expectations about the future play in social situations sets up a two-way connection between participants’ thinking and the situation in which they participate, which has a deleterious effect on both: it introduces an element of contingency or uncertainty into the course of events, and prevents the participants’ view from qualifying as knowledge.” As a result, expectations have a tendency to diverge from outcomes.

Reflexivity entails a mismatch between the participants’ views and the real state of affairs. Classical economic theory, of course, eschews subjective notions such as reflexivity on the grounds that economics is a hard science that should only deal with objective matters. As a result, it denies that there could ever be a reflexive interconnection between supply and demand, for instance. However, experience
demonstrates that treating economic subject matter the same way we treat inert natural phenomena is misguided.

The Theory of Reflexivity
The human brain’s capacity to process information is limited, but the amount of information available to be processed is unlimited. This is one reason our knowledge of the world is bound to be incomplete. The mind “cannot fully overcome the fact that it is part of the situation it seeks to comprehend.”

Reflexive processes arise when there is a divergence between the subjective and objective aspects of a situation. A key principle here is that misconceptions and misunderstandings introduce an element of indeterminacy into the course of events. Reflexivity theory rejects the view that market activity is predictable and susceptible to scientific and statistical laws. Demonstrably reflexive events in the markets may occur only intermittently, but reflexive processes tend be of great importance because they frequently alter the course of history.

The concept of reflexivity is sometimes difficult to get across because our philosophical tradition has more often than not failed to recognize that reason and reality are interconnected. The Enlightenment tradition, for instance, conceptualized reason as a searchlight that illuminated the dark recesses of reality (but never altered the reality it discovered). The Enlightenment tradition largely failed to acknowledge the existence of a manipulative function.

The Enlightenment may have placed too much stock in reason, but there is little doubt that doing so was a fertile fallacy: a fertile fallacy is a flawed idea that leads to many positive results before the deficiencies of original idea are discovered.

The philosopher Karl Popper was dubious of reason’s ability to establish truths beyond all doubt. He contended that the scientific method works best by maintaining a comprehensively skeptical attitude: “scientific laws should be treated as hypotheses which are treated as provisionally valid unless and until they are falsified.” Hypotheses that do not make predictions, explain phenomena, or that cannot be tested (potentially falsified) are not scientific. In Popper’s view, a hypothesis that survives severe and repeated testing will be more useful. This view has application to the financial markets as well.

Popper believed that the same methods we use to pursue the truth about natural phenomena were applicable to social phenomena as well. There is a flaw here, however, since there are important differences between natural and social phenomenon. In particular, political discourse does not always aim at truth. The pursuit of truth is a precondition of an open society, but politicians who seek to perpetuate and extend their power can distort reality, even in an open society. For instance, George W. Bush manipulated public opinion to invade Iraq and launch a never-ending War on Terror. He
did so in a bid to consolidate American supremacy, but he has instead “caused a precipitous decline in American power and influence and lost political support in the process.”

Popper believed that political discourse should aim at truth. Too often, however, politicians manipulate political discourse for their own ends. Here, a democratic electorate needs to reward leaders that are truthful and punish those that are deceitful.

Why should the pursuit of truth take priority over the pursuit of power? For one reason: misconceptions and misjudgments are liable to lead to deleterious consequences.

The Enlightenment tradition errs in assuming that reason can uncover an objective reality independent of the process of thinking itself. The Postmodern tradition, on the other hand, goes to the opposite extreme in positing the impossibility of discerning any kind of objective reality whatsoever. Reflexivity is corrective to both because it recognizes that thinking is a part of reality.

While the Enlightenment tradition may have placed too much faith in reason, the postmodern tradition errs in putting too little faith in reason as a reality-checker. This is why Postmodernism may unwittingly encourage totalitarian ideologies and closed societies. When a top Bush administration official, presumably Karl Rove, told the journalist Ron Susskind that, “We’re an empire now, and when we act, we create our own reality,” he was really articulating a postmodern attitude.

The American public is only now beginning to wake up from the nightmare the Bush administration has created. “Reality is a moving target, yet we need to pursue it.” With the Bush administration, the pursuit of power took precedence over the pursuit of truth. We need to reverse that equation in order to reinvigorate our commitment to an open society.

The Bush administration succeeded in its manipulations because it exploited our strongest emotion, the fear of death. Rational arguments proved no match for their emotional appeals. However, if we are to reestablish higher levels of political discourse, we must “realize that reality matters even if it can be manipulated.” We must also recognize that ideologies that claim to have a monopoly on ultimate truth are mistaken. Radical fallibility is a prudent working hypothesis; we can gain some insight into reality, but because reality is a moving target we are bound to get many things about it wrong. Recognizing our fallibility is essential for allowing us to correct our misconceptions.

Both the War on Terror and the present financial crisis originated from misjudgments and misconceptions. The War on Terror has proven to be a misleading metaphor that has engendered many adverse consequences for the United States. And the current economic crisis has arisen because of a misunderstanding of how financial markets actually work.
Open societies, however, are self-correcting precisely because they recognize they are imperfect and amenable to self-improvement.

Reflexivity in Financial Markets

Equilibrium theory and the theory of reflexivity are incompatible; only one can be valid. Equilibrium theory suggests that the pursuit of self-interest leads to the optimum allocation of resources. It also assumes perfect knowledge is possible, markets function optimally if they are unregulated, and that economic axioms can be established that are as sound as those found in Euclid or the natural sciences. This point of view has undergirded laissez-faire economics since the 19th century.

The theory of reflexivity, on the other hand, postulates that markets always operate with a prevailing bias, but in the normal course of events, they tend to correct their own excesses. “Occasionally the prevailing bias can actually validate itself by influencing not only market prices, but also the so-called fundamentals that market prices are supposed to reflect.” Here, it is important to restate the crux of reflexivity theory: the prevailing bias influences the market price, which in turn influences the fundamentals. Thus, a change in fundamentals can then reinforce the initial bias in a “self-reinforcing but ultimately self-defeating process” that we recognize as the boom-bust.

The typical boom-bust plays out in eight stages:

1. A prevailing bias and a prevailing trend.
2. Acceleration of the trend.
3. A period of testing and price setbacks.
4. If the bias and price survive the testing, then a point is reached where participants no longer believe the usual rules apply.
5. Market values become unhinged from reality.
6. A twilight period occurs where participants continue to play the game though they no longer believe in it.
7. A tipping point is reached where the bias is reversed.
8. The crash ensues.

Reflexivity, of course, does not always lead to bubbles. Many reflexive processes get corrected before the prevailing bias generates a vicious cycle. However, “because financial markets do not tend towards equilibrium they cannot be left to their own devices.”

The new paradigm of reflexivity contends that markets are always wrong. Markets, however, do have the ability to correct themselves, though they move away from equilibrium as often as the move towards it. Markets, in short, are fallible, just as individuals are. Regulators are fallible too, but in general, markets are less susceptible to breaking down when there is supervision. In particular, the theory of reflexivity suggests that we need to be more vigilant when it comes to the use of leverage.
The Super-Bubble Hypothesis
We are in the midst of the most serious financial crisis since the Great Depression. The financial system is on the brink of a breakdown and is being held together only by tremendous effort. The present crisis will not be a replay of the Great Depression – the banking system will not be allowed to collapse – but we are at the end of an era of easy credit.

We are witnessing the bursting of not one but two bubbles: the housing bubble and a super-bubble inflated by cheap credit. The housing bubble is straightforward; it was spawned and sustained by the misconception “that the value of collateral was not affected by the willingness to lend.” Citibank’s CEO Chuck Prince described the predicament of prolonged easy credit this way: “When the music stops, in terms of liquidity, things will get complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” Those words, of course, were spoken just before the subprime crisis manifested.

The super-bubble is more complicated and has to do with credit-creation and an excessive faith in the “magic of the marketplace.” Put simply, the super-bubble has been inflated by three trends: 1) increasing credit expansion, 2) the globalization of financial markets, and 3) the elimination of regulatory mechanisms.

Globalization, contrary to the doctrine of market fundamentalism, has not brought about a level playing field. Instead, the financial system has worked to the advantage of developed countries in so far as the savings rate of the developed world is used to finance consumer spending in the United States. This imbalance has grown because developing countries like China are eager to produce, while Americans are eager to consume. The situation became unsustainable, however, with the advent of the housing bubble. After all, as households found themselves overextended, consumption was bound to fall. Thus, the housing bubble was not an isolated phenomenon, but a trigger for a larger unwinding.

There is a lot more to the super-bubble story. Complex financial instruments that were often unsound and largely unregulated, not to mention rising energy prices and the weakening dollar (a byproduct of the Iraq War), have curtailed credit availability. The upshot of all this is that the United States is facing a certain economic slowdown and its position at the center of the global financial system is eroding.

Conclusion
Recession in the United States is all but inevitable. Strong economic conditions in the rest of the world – particularly a rising China and India – will counterbalance a slowdown here at home. We have experienced a long period of relative stability based on the United States’ position as the world’s dominant power and the dollar’s role as the world’s reserve currency. This era is ending. As a result, we are probably entering a period of political and financial instability, but a new world order will emerge that no one power can dominate.
Housing prices, which have already declined 10% since the housing bubble burst, are likely to decline another 20%. Since the U.S is facing both a recession and a flight from the dollar, it is in a double bind – it cannot lower interest rates without feeding inflationary prices and further weakening the value of the dollar. Unfortunately, the Bush administration has exhibited little evidence that it understands the complexity and the depth of the problems the country faces. Eventually, “the U.S. government will have to use taxpayer dollars to arrest the decline in house prices.”

No one knows with certainty what lies ahead. Today, however, “we are in a period of forced deleveraging and the destruction of wealth. It is difficult to escape.” The Bush administration is waiting for the housing market to hit bottom. Its market fundamentalism has blinded it to the fact that declines can be self-reinforcing, as the theory of reflexivity predicts. We should expect better from the next administration.


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