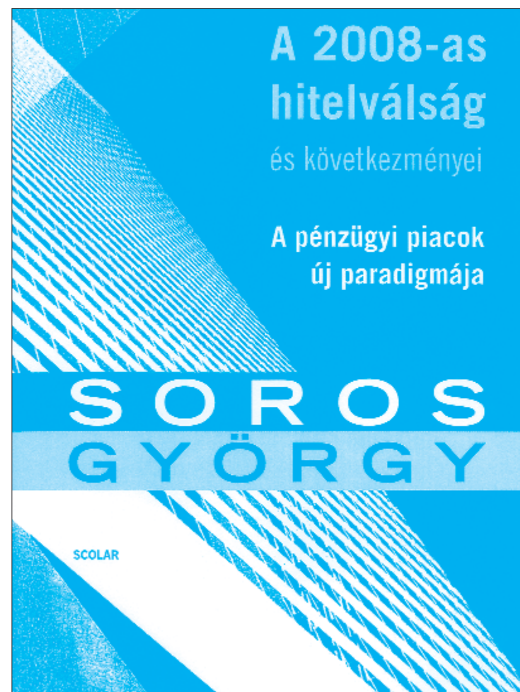
George Soros

The credit crisis of 2008 and what it means[*]



SCOLAR KIADÓ, 2008

Nothing proves better that events are accelerating and that the world is becoming a village than what can be read on the second page of the book reviewed here and of its Hungarian translation (Soros 2008a, 2008b). The two books were published in the same year. The Hungarian public could not only read the book in Hungarian already in the year of its publication in the United States and the United Kingdom but this review, too, has followed shortly afterwards, in the first months of the following year.

INTRODUCTION, BACKGROUND

What is stated above proves not only the great and increasing rapidity with which ideas can be spread but also the enormous importance of the events dealt with and the ideas pre-sented in this book. The importance of these cannot be better described than by the author in the first sentences of the *Introduction* of his book. "We are in the midst of the worst financial crisis since the 1930s[1]. In some way it resembles other crises that have occurred in the last twenty-five 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. The 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 twenty-five years. To understand what is going on we need a new paradigm. The currently prevailing paradigm, namely that financial markets tend towards equilibrium, is both false and misleading; our current troubles can largely be attributed to the fact that the international financial

[*] This reviewer is indebted – with the usual reservations – to László Csaba and Dóra Győrffy for their valuable comments and help

system has been developed on the basis of that paradigm. The new paradigm I am proposing 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" (p. 7).

In the further parts of the Introduction the author describes his subjective reason for writing this book. Already in his first book, The Alchemy of Finance (1987), he "expounded the theory of reflexivity", but it "was not taken seriously in academic circles" (p. 8). "It is difficult to gain attention for an abstract theory, but […] the current situation provides an excellent opportunity to demonstrate its relevance and importance." This "consideration" was what "weighted most heavily in [his] decision to publish his book" (pp. 9–10). The reasoning expounded already in the former book is simple. "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 importantly, market prices affect the socalled fundamentals that they are supposed to reflect. Market prices do not deviate from a theoretical equilibrium in a random manner, as the current paradigm holds. […] 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." (p. 10) The attempt to evaluate the book will follow at the end of this review, but these few sentences seem enough to support the statement that the approach presented in these few sentences is realistic.

The Introduction is followed by a second introduction bearing the title "*Setting the Stage*" and describing the course of events beginning August 6, 2007 when "American Home Mortgage, one of the largest U.S. independent home loan providers, filed of bankruptcy after laying off the majority of its staff" (p. 13), which is considered generally as the setting off of the crisis. "The crisis was slow in coming, but it could have been anticipated several years in advance. […] For thirty-one consecutive months, the base inflation-adjusted short-term interest rate was negative. […] When money is free, the rational lender will keep on lending until there is no one else to lend to. […] Investment banks on Wall Street developed a variety of new techniques to hive credit risks off to other investors. […] From 2000 until mid-2005, the market value of existing homes grew by more than 50 percent, and there was a frenzy of new construction. […] Credit standards collapsed. […] The bankers and the rating agencies grossly underestimated the risks. […] Securitization[2] became a mania. […] It was bound to end badly. […] Once the crisis erupted, financial markets unraveled with remarkable rapidity. Everything that could go wrong did. […] Distress spread from residential real estate to credit card debt, auto debt, and commercial real estate. […] Over the past several decades the United States has weathered several major financial crises, […] but the current crisis is of an entirely different character. It has spread from one segment of the market to others, particularly those that employ the newly created structured and synthetic instruments[3]. […] Both the financial markets and the financial authorities have been very slow to recognize that the real economy is bound to be affected. […] One cannot escape the conclusion that both the financial authorities and market participants harbor fundamental misconceptions about the way financial market functions. […] I shall argue that the global financial system has been built on false premises. […] In Part 1, I shall lay out the conceptual framework. […] In part 2, I shall apply that framework to the present moment in history." (pp. 15–28)

PERSPECTIVE

THE CORE IDEA The first chapter of *Part I*, "*Perspective*", *Chapter 1* describes "*The core idea*" presented already in the earlier works of this author. "We are part of the world we seek to understand," and "the fact that we are part of the world poses a formidable obstacle to the understanding of human affairs" (p. 3). He distinguishes the "*cognitive function*", our attempt "to understand the world in which we live" and the "*participating function*", our attempt "to make impact on the world and change [it to our] advantage", which latter may be "more appropriate to call" the "*manipulative function*" (id.). The obvious consequence of this is that "the phenomena do not consist only of facts but also of intentions and expectations about the future. The past may be uniquely determined, but the future is contingent on the participants' decisions. Consequently the participants cannot base their decisions on knowledge because they have to deal not only with present and past facts but also with contingencies concerning the future" (p. 4) This leads to the notion of reflexivity to be dealt with in more detail later on: "In reflexive situations each function deprives the other of the independent variable which it would need to produce determinate result" (p. 5). The demand and supply curves are not independently given but interfere with each other and therefore they are not predetermined facts. "Take the stock market, for example. People buy and sell stocks in anticipation of future stock prices but those prices are contingent on the investors' expectations. *The expectations cannot qualify as knowledge*" (id., italics added by reviewer).

This leads to sharp criticism against conventional economic theory. "Classical economists simply assumed that market participants base their decisions on perfect knowledge" (id.). "I contend that rational expectations theory totally misinterprets how financial markets work" and therefore "is no longer taken seriously outside academic circles" (p. 6). This is followed by philosophical argumentation leading to the conclusion that humans "are obliged to form a view of the world, but the view cannot possibly correspond to the actual state of affairs" (p. 11).

AUTOBIOGRAPHY OF A FAILED PHILOSOPHER Chapter 2, "Autobiography of a failed philosopher" deals with the personal experiences of the author and his father and also with the author's contact in Vienna with Karl Popper and his views. The reason for the inclusion of this chapter, which cannot be dealt with here in de-tail for lack of space, is indicated in the last sentence of Chapter 1. "I learned at an early age how ideologies based on false premises can transform reality" (p. 11). Europeans and particularly Eastern Europeans can best understand the inherent validity and also the importance of this statement that underpins, very obviously, the author's ideas. This chapter, however, is not a digression of personal character inserted into the text of this book but a description of the origin and development of his ideas.

THE THEORY OF REFLEXIVITY *Chapter 3* expounding the author's views on "*The theory of reflexivity*" can also be dealt with here only in lesser detail, emphasizing only what this reviewer considers the most impor-tant. The author himself introduces it with the following remark: "Readers may find this chap-ter somewhat repetitive and hard going. Those who are only interested in the financial mar-kets may skip it" (p. 25).

In this reviewer's view, the most interesting element of this chapter is the parallel drawn between Enlightenment and postmodern thinking. "The philosophers of the Enlightenment put their faith in reason; they saw reality as something separate and inde-

pendent of reason, and they expected to provide a full and accurate picture of reality" (p. 32). The postmodern thinking sees the fallacies of this reasoning, but "the postmodern attitude towards reality is much more dangerous. While it has stolen a march on the Enlightenment by discovering that reality can be manipulated, it does not recognize the pursuit of truth as a requirement. Consequently, it allows the manipulation of reality go unhindered" (p. 38). This statement leads him to a frontal attack on his archenemy, the Bush administration: "I now see a direct connection between the postmodern idiom and the Bush administrations' ideology" (p. 41). One of this administration's senior advisers (and, consequently, the administration itself) "did not merely recognize that the truth can be manipulated, he promoted the manipulation of truth as a superior approach" (pp. 42–43). "This leads to the paradoxical conclusion that the higher standards in politics were based on an illusion, and they were undermined by the discovery of truth, namely that reality can be manipulated" (pp. 45–46). This, in my opinion most important part of this chapter is closed with the following statements of moral character: "I believe political discourse used to abide by much higher standards of truthfulness and respect for the opponents' opinion in the first two hundred years of democracy in America than it does today" (p. 45). "To reestablish those higher standards that used to prevail, people must come to realize that reality matters even if it can be manipulated" (p. 46).

REFLEXIVITY OF FINANCIAL MARKETS In *Chapter 4, "Reflexivity of financial markets"* the author leaves "the realm of abstractions" in which he has "delved" (p. 51), and begins to deal with realities, the veritable problems of financial markets, problems in which the readers are probably more interested than in the philosophical speculations of the first three chapters.

The first few pages discuss equilibrium theory and rational expectations theory and add only some details to what has been written previously. The fundamental theorem is presented rather bluntly in the first sentences of the section on *"A contradictory theory".* "I contend that *financial markets are always wrong* (italics added by reviewer) in the sense that they 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. […] The change in the fundamentals may then reinforce the biased expectations in an initially self-reinforcing but eventually self-defeating process. Of course such boom-bust sequences do not occur all the time. Most often the prevailing bias corrects itself before it can affect the fundamentals. But […] they can occur […]. When they occur, boom-bust processes can take on historic significance. That is what happened in the Great Depression, and that is what is unfolding now, although it is taking different shape" (pp. 57–58). As we can see, in this analysis already, a reference is made to the current problems to be dealt with later on, in Chapters 5–8, while this chapter primarily focuses on past events rather than current problems.

The first such past event was the conglomerate boom of the 1960s. At this time companies "could attain a higher multiple simply by going on an acquisition spree" (p. 59), i.e. buying other companies. "The misconception […] was the belief that companies should be valued according to the growth of their reported per share earnings no matter how the growth was achieved", i.e. by assuming that "equity leveraging[4], that is, selling stock at inflated valuations can generate earning growth" (p. 60). "When stock prices started to fall, the decline fed on itself" (id.). This was therefore a classical boom-bust process: the boom was built on

the increase of stock prices that, eventually, had to come to a stop and at this point the collapse of the boom was unavoidable. The second such event was the case of the real estate investment trusts. The shares of the first such trusts "nearly doubled in price in the space of a month or so. Demand generated supply, and a host of new issues came to the market. When it became clear that the supply [...] was inexhaustible, prices fell" (p. 62), and the boom collapsed.

The most important was, however, "the international banking crisis of the 1980s" (p. 64). The author's fundamental contention is that in case of private loans "bubbles arise when banks treat the value of [the collateral, of] the real estate as if it were independent of the banks' willingness to lend against it" (pp. 64–65). The value of the real estate, however, is not given, as conventional theory and also banks assume, but the willingness of the banks to lend against it increases its value. This is therefore a process that feeds on itself and must come to a stop; the stop, however, leads to collapse. When "the debtors were sovereign countries, [banks] pledged no collateral" (p. 65), and credits were given on the basis of the creditworthiness of the countries. The countries' creditworthiness was, however, increased by the banks' willingness to give credit, which was therefore again a process that fed on itself and had to come to a stop and collapse. The thesis is therefore clear: the banks' activity influences fundamentals, the valuation of real estates and the economic state of the countries; credits are given because the banks' activity increases the value of the real estate and improves the position of the countries. This process must, however, come to a halt sooner or later, followed by a collapse, if this self-reinforcing process surpasses a certain limit or an adverse outside shock occurs.

BOOM/BUST MODEL The *boom-bust model* presented in the next section is a generalization of what has been written above and, according to it, "the drama unfolds in eight stages" (p. 65). It "has a pecu-liarly asymmetric shape. It tends to start slowly, accelerate gradually and then fall steeper than it has risen" (p. 66). A theoretical and three empirical charts are presented and the empirical ones are obviously conform to the theory and the theoretical charts. Other forms of reflexivity are also possible, and "in free-floating exchange rate regimes the reflexive relationship tends to generate large multi-year waves" (p. 70).

The economic policy consequences of the above considerations and of the empirical evidence are straightforward and farreaching. *"Because financial markets do not tend towards equilibrium, they cannot be left to their own devices* (italics added by reviewer). Periodic crises bring forth regulatory reforms" (p. 71). In sharp contrast to the above, *"the prevailing paradigm asserts that financial markets tend towards equilibrium.* That has led to the notion that actual prices deviate from a theoretical equilibrium in a random manner. While it is possible to construct theoretical models along these lines, *the claim that those models apply to the real world is both false and misleading.* It leaves out of account the possibility that the deviations may be self-reinforcing in the sense that they may alter the theoretical equilibrium. When that happens, *risk calculations and trading techniques based on these models are liable to break down.* [...] *This is at the root of the current financial crisis"* (italics added by reviewer, pp. 73–74.)

A *"new paradigm"* is therefore needed, and its theoretical point of departure, as has been stated before, is that "by applying the postulate of radical fallibility to financial markets, one can assert that *instead of being always right, financial markets are always wrong.* [...] To be specific: *financial markets cannot predict economic downturns accurately, but they can cause them.* [...] Bubbles often lead to financial crises. Crises, in turn, lead to the regulation of

financial markets. That is how *the financial markets are best interpreted as a historical process, and that is why this process cannot be understood without taking into account the role of the regulators.* 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. […] Most of the reflexive processes involve an interplay between markets and regulators, [but] it is important to remember that regulators are just as fallible as the participants. […] That alone is sufficient to justify my claim that the behavior of markets is best regarded as a historical process" (pp. 76–77, italics added by reviewer).

This is something fundamentally different from traditional theory and it is easy to understand that the author's criticism of the classical theory is annihilating. "Market fundamental-ists 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 claim-ing that regulations ought to be abolished on account of their fallibility. That happens to be the inverse of the Communist claim that markets ought to be abolished on account of their fallibility. […] It will advance our understanding of reality if we recognize the ideological character of market fundamentalism. The fact that regulators are fallible does not prove that markets are perfect. It merely justifies re-examining and improving the regulatory environment" (p. 77).

After these considerations of mostly theoretical character let us now turn to *Part II: "The current crisis and beyond".*

THE CURRENT CRISIS AND BEYOND

THE SUPER-BUBBLE HYPOTHESIS *Chapter 5: "The super-bubble hypothesis"*, which may be considered as the central chap-ter of this book, tries to apply the theoretical apparatus shown above to the present situation and also to point to future developments that may be expected. It is therefore of necessity to review it in a very detailed form.

The chapter begins with very important and very explicit statements: "We are in the midst of a financial crisis the likes of which have not been seen since the Great Depression of the 1930s. To be sure, it is not the prelude to another Great Depression. History does not repeat itself. The banking system will not be allowed to collapse as it did in 1932" (p. 81). Nevertheless, "this [crisis] will have farreaching consequences. It is not business as usual but the end of an era" (id.). This is followed by the concept to be developed in this chapter, i.e. that in the present situation "there is not just one boom-bust process or bubble but two: the housing bubble and what I shall call a longer-term super-bubble. […] The two bubbles did not develop in isolation: they are deeply imbedded in the history of the period" (p. 82). Finally, the statement that no new Great Depression will develop is supported by the following considerations: "The current situation cannot be understood without taking into account the economic strength of China, India, and some oil- and raw material-producing countries; the commodities boom; an exchange rate system that is partly floating, partly tied to the dollar and partly in between; and the increasing unwillingness of the rest of the world to hold dollars" (p. 82). These views will be expounded in a more detailed form later, in Chapter 7.

The emergence of the "U.S. housing bubble" (p. 82), according to the views of the author, can be traced back to a number of longer term developments that are shown in Charts 1 to 7. The U.S. saving rate declined to practically zero and housing prices increased enormously. The growth of U.S. household debt and the ratio of structured finance within total rated

revenue was also enormous. Credit quality declined, which can best be shown by the "growing share of subprime and Alt-A origination"[5] (p. 83). "Toward the end, houses could be bought with no money down, no questions asked" (id.). Under such conditions the crisis was foreseeable and practically unavoidable as already stated in the second introduction "Setting the stage"; the details can be found in the book.

As to the super-bubble hypothesis, "superimposed on the U.S. housing bubble there is a much larger boom-bust sequence which has finally reached its inflection, or crossover, point. It consists of an excessive reliance on the market mechanism. President *Ronald Reagan* called it the magic of the marketplace. I call it market fundamentalism. It became the dominant creed in 1980 when Reagan became president in the United States and *Margaret Thatcher* prime minister in the United Kingdom, although its antecedents go back much further. It was called laissez-faire in the nineteenth century. Market fundamentalism has its roots in the theory of perfect competition. [...] In the post World War II period it received a powerful fillip from the failures of communism, socialism, and other forms of state intervention. That impetus, however, rests on false premises. [...] Financial markets do not necessarily tend towards equi librium; left to their own devices they are liable to go to extremes of euphoria and despair. For that reason they are not left to their own devices; they have been put in the charge of financial authorities whose job is to supervise them and regulate them. Ever since the Great Depression, the authorities have been remarkably successful in avoiding any major breakdown in the international financial system. Ironically, it is their success that has allowed market fundamentalism to revive. When I studied at the London School of Economics in the 1950s, laissez-faire seemed to have been buried for good. Yet it came back in the 1980s. Under its influence the financial authorities lost control of financial markets and the super-bubble developed" (p. 92).

"The super-bubble combines three major trends, each containing at least one defect. First is the longterm trend towards everincreasing credit expansion. [...] 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[6]. 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 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 towards equilibrium and deviations are random. The super-bubble ties together the three trends and the three defects" (p. 93).

If what has been told until now on market fundamentalism is a dethronement, what is told on globalization is a blasphemy. "The globalization of financial markets was a very successful market fundamentalist project. If financial capital is free to move about, it becomes difficult for any state to tax it or to regulate it because it can move somewhere else. This puts financial capital into a privileged position. Governments often have to pay more heed to the requirements of international capi-

tal than to the aspirations of their own people. That is why the globalizations of financial markets served the objectives of the market fundamentalists so well. […] Globalization did not bring about the level playing field that free markets were supposed to provide according to the market fundamentalist doctrine. […] The way the system works, the United States, which enjoy veto power in the Bretton Woods institutions, […] is 'more equal' than the others. […] As the barriers to capital movements were removed the savings of the world were sucked up to the center and redistributed from there" (pp. 95–96).

The above statements may appear as populist utterances but they are followed by thoroughgoing analysis. The gradual lifting of restrictions and the asymmetry of the system described above "combined with the asymmetric incentive for credit expansion in the developed world, sucked up the savings of the world from the periphery to the center and allowed the United States to develop a chronic current account deficit. […] This was a perverse situation because capital was flowing from the less-developed world to the United States and both the current account and the budget deficits of the United States served as major sources of credit expansion. Another major source was the introduction of new financial instruments and the increased use of leverage by the banks and some of their customers, notably hedge funds and private equity funds. Yet another source of credit expansion was Japan. […] These imbalances could have continued to grow indefinitely because willing lenders and willing borrowers were well matched. There was a symbiotic relationship between the United States, which was happy to consume more than it produced, and China and other Asian exporters, which were happy to produce more than they consumed. The United States accumulated external debt, China and the others accumulated currency reserves. The United States had low saving rates, the others high ones" (pp. 96–97). "This situation became unsustainable with the development of a housing bubble in the U.S. and the introduction of financial innovations based on a false paradigm. [The housing bubble] 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 in the financial system by recent innovations. *That is how the housing bubble and the super-bubble are connected*" (p. 98, italics added by reviewer).

There is therefore the fundamental "difference between this crisis and the periodic crises that have punctuated finical history since the 1980s. […] Those who kept insisting that the subprime crisis was an isolated phenomenon lacked a proper understanding of the situation. The subprime crisis was merely a trigger that released the unwinding of the super-bubble" (pp. 98–99). This is followed by a longer argumentation posing the question whether the author's thesis is valid or not, but the author, returning to the "three major trends" (p. 93) shown above, comes to the conclusion that "these three factors render an economic slowdown virtually inevitable and turn [what has happened now] into the end of an era" (p. 101). Nevertheless, he adds that "we must beware of laying too much emphasis on the super-bubble. We must not endow it with magical powers the way President Reagan did with the marketplace. There is nothing predetermined or compulsory with the boom-bust pattern. […] I want to caution against the pitfalls that await those who seek to fit the course of events into a predetermined pattern. […] The right way to proceed is to fit the pattern to the actual course of events" (pp. 101–102). The author emphasizes therefore that the future is not predetermined and human foresight is limited but leaves no doubt that, in his opinion, we are at the end of an era and at a turning point of human history.

This chapter is closed with similar statements. "I believe that the theory of reflexivity can explain the current state of affairs better than the prevailing paradigm, but I have to admit that it cannot do what the old paradigm did. It cannot offer generalizations in the mold of natural science. It contends that social events are fundamentally different from natural phenomena, they have thinking participants whose biased views and misconceptions introduce an element of uncertainty into the course of events" (p. 103). It can therefore be assumed that we are at the end of an era and at a turning point of human history, but it cannot be assumed that we can foresee the future with certainty.

AUTOBIOGRAPHY OF A SUCCESSFUL SPECULATOR *Chapter 6, "Autobiography of a successful speculator"* is even less a digression of personal character inserted into the text of this book than Chapter 2, *"Autobiography of a failed philosopher"* was. It is a description of the development of the banking sector in the author's active lifetime, since 1950. "At the end of World War II […] banks and markets were strictly regulated. […] International financial transactions were subject to strict regulation by most countries and there was very little international capital movement. […] Banks at the time were considered the stodgiest of institutions. Managements had been traumatized by the failures of the 1930s, and safety was the paramount consideration, overshadowing profit and growth" (pp. 106–109). This is followed by the description of the two oil shocks, of "the technology bubble that burst in 2000 and of the terrorist attack of September 11, 2001" (p. 116) and their consequences, as well as the "shocking abdication of responsibility on the part of the regulators" (p. 117). Even the activities of FED presidents *Alan Greenspan* (p. 118) and Ben Bernanke (p. 119) are evaluated, and the chapter ends with the author's following revelation: "when the crisis erupted in August 2007, I considered the situation grave enough that I did not feel comfortable leaving the management of my fortune to others, [and] I resumed control" (p. 121). In my opinion this chapter does not explicitly state but implies – if other parts of the book are also taken into consideration – that the banking industry will be led in a much more conservative way in future and it will be put under effective control once again.

MY OUTLOOK FOR 2008 *Chapter 7* bearing the title *My outlook for 2008* is subdivided into sections headed by the dates when these sections were presumably written.

The most important statements can be read in the first section dated *January 1, 2008,* and it seems reasonable to cite them.

"1. A sixty-year period of credit expansion based on the United States exploiting its position at the center of the global financial system to control over the international reserve currency has come to an end" (p. 122).

"2. One can expect some longerlasting changes in the character of banking and investment banking" (p. 123).

"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 of the oil-producing countries are experiencing dynamic developments which may not be significantly disrupted" (p. 124).

"4. The United States during the Bush administration failed to exercise proper political leadership" (id.).

These statements are followed by the author's conjectures about the state and future of the most important participants and determinants of the world economy. As to the United States, "both investors and the general public suffer from a misconception. They believe that the financial authorities […] will

do whatever it takes to avoid a recession. I believe that they are not in a position to do so partly because of the commodity boom and partly because of the vulnerability of the dollar (the two are mutually self-reinforcing)" (p. 125). The obvious consequence of this is that "I believe that the renminbi will be allowed to appreciate at a faster rate" (id.). "Europe is liable to be affected almost as badly as the United States" (p. 128). "China is undergoing a radical structural transformation, and the asset bubble engendered by negative real interest rates is facilitating the process. […] No doubt a bubble is in formation, but it is in a relatively early stage, and there are powerful interests at work to keep the bubble going" (p. 129). Nevertheless, "China will sail through the current financial crisis and subsequent recession with flying colors and gain considerable relative strength. […] China is likely to challenge the supremacy of the United States much sooner than could have been expected when George W. Bush was elected president" (p. 131). Of course an utterance against this archenemy is not spared: "What an ironic outcome for the Project for a New American Century!" (Id.) In India "the growth rate has now more than doubled. […] The discovery of offshore natural gas promises to make India energy self-sufficient within the next few years" (pp. 131–132). "Another source of strength for the world economy is to be found in some of the oil-producing countries of the Middle East (p. 133), [because] these states are accumulating reserves at an impressive rate, […] [and] are likely to favor investing in the developing world […] [which] is likely to reinforce the positive performance of the developing economies" (pp. 133–135). The ensuing sections do not modify this picture in any substantial way.

SOME POLICY RECOMMENDATIONS *Chapter 8* presents *"Some policy recommendations"* which follow directly from what has been written previously. We must not be surprised that the first statement and the first rec-ommendation are the following: "Only a Democratic president can be expected to turn things around and lead the nation in a new direction", and, respectively: "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" (p. 142). This does not mean, however, any excessive state interference: "Markets should be given the greatest possible scope compatible with maintaining economic stability" (p. 143). As a "specific measure that could help relieve the credit crisis is the establishment of a clearing house or exchange for credit default swaps" that seems necessary as "forty-five trillion dollars (!!!) worth of contracts are outstanding" (p. 145). The next question is: "What is to be done about the mess created by the bursting of the housing bubble", considering that "about 40 percent (!!!) of the 7 million (!!!) subprime loans outstanding will default in the next two years" and that "the human suffering caused by the housing crisis will be enormous" (pp. 146–147). The detailed discussion of the concrete proposals is impossible here but it can be seen that the "mess" is extreme and the way out is far from being obvious.

CONCLUSION

The *Conclusion* repeats the most important elements of the previous argumentation and its last paragraph shows best the veritable problem. "I should like to end with a plea. 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 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. I hope to participate in a lively debate" (pp. 159–160.)

This conclusion shows best that the subprime crisis, which first appeared to be an isolated problem the likes of which could be solved in the past with no major consequences, triggered a US credit crisis which, in turn, triggered an international financial crisis that brought to the fore a number of fundamental problems which were known but were shelved for fear of facing them. We must suppose that the world order of the years before this crisis will never return, it will take a long time until the new a new world order is shaped, and that this time will be hard for all of us. The greatest merit of this book is to show the depth of the problems before us and the weight of the task facing us.

This looks like the end of this review but I have some remaining tasks to solve and some questions to answer.

The *first question* is whether the author's fundamental theses that *"financial markets do not tend towards equilibrium, they cannot be left to their own devices"* (p. 71, italics added by reviewer), and that *"financial markets are always wrong"* (p. 76, italics added by reviewer) are valid, considering that traditional economic theory and the practice built on it hold that speculation is beneficial and even unavoidable. My contention is that these theses of Soros are not only valid but they can be supported by means of neoclassical analysis, and that financial markets are wrong not only in the sense that they bring disruptive forces to the fore but also in the sense that they distort prices. This claim can be backed in the most simple way by referring to a book published sixty years ago, *Abba P. Lerner's* Economics of control (1947). This book draws all its conclusions from the thesis that the general prevalence of perfect competition is the best possible state of affairs, and devotes a whole chapter to competitive speculation.

The summary of this Chapter is the following: "The social utility of competitive speculation is more certain than that of simple production. It is beneficial for the rest of society even if the speculator is mistaken and incurs a loss, and even when he sells short. Hostility to speculation is mistaken and arises in part from identifying productive or competitive speculators with aggressive or monopolistic Speculators [written in this case with capital S]. The profits from speculation are best eliminated by increasing the amount of speculation" (p. 13). This is, obviously, the classical and neoclassical view on which the prevalent system of stock and merchandise exchanges are built.

In Lerner's book, the title and the first paragraph of the first Section of the Chapter *"Competitive speculation"* are the following: *"The social utility of competitive speculation is more certain than that of simple production"* (p. 88). "All perfectly competitive speculation is in the social interest whether the optimum division of each factor between the different products is reached or not. It always improves on the situation, bringing it nearer to the optimum. It is strange that this should be more certainly so in the case of speculation than on the case of production in the ordinary sense which usually receives much grater social approbation. Simple production of a particular good may be perfectly competitive and yet not contribute at the margin to bringing out the best use of the factor. It may be harmful socially because there is an aberration from the optimum in the production of the alternative products. […] But perfectly competitive speculation cannot have its good works nullified by what gets on anywhere in the economy because it completes the whole cycle by itself in taking

goods from points where they are cheaper to others where they are dearer and so from points where the value of the alternative use, the *marginal social cost,* is lower than the value of the actual use, the *marginal social benefit.* Thus it always tends to bring *marginal social cost* closer to *marginal social benefit* (id.)."

To express this argumentation in a more concise way, in the case of ordinary production, marginal social cost is equal to marginal social benefit only if this condition is fulfilled everywhere, as a price distortion anywhere may cause distortion everywhere. This problem does not arise in the case of speculation as speculation involves only a single piece of goods in some place at some time and is therefore unaffected by distortions related to other goods. Speculation can be harmful only if "speculators are able, because they are very rich or because they can organize many people into combinations, to affect the price and thus to frustrate any attempts to bring about an optimum allocation of goods. […] We may call this aggressive or monopolistic Speculation" (p. 69). The moral is simple and it is in full conformity with or is even the best expression of the teachings of classical economics: perfect competition is good and monopolies are bad because they distort prices. Monopolies are not bad because they exist but because they distort prices.

This is where the *Soros* theory enters the picture. Speculators can affect prices not only if they are very rich or if they organize themselves into combinations but if they behave in a uniform way, led by the Keynesian animal spirit, without organizing themselves into combinations. A large unorganized group led by the same misconception distorts prices just as well as organized monopolies do. As a result, the theses of Soros that *"financial markets do not tend towards equilibrium, they cannot be left to their own devices"* (p. 71, italics added by reviewer), and that "financial markets are always wrong" (p. 76, italics added by reviewer) are therefore valid even within the context of classical economics as unorganized groups led by the same misconception act and distort prices in the same way as monopolies do. This means that speculation is not only wrong because it involves excesses of exuberance and despair and consequently leads to crises but also because it distorts prices.

This contention is very similar to the Keynesian thesis that free markets do not necessarily bring about full employment, and, if they do not, state intervention is necessary. This raises, however, the *second question.* If state intervention is necessary when financial markets run amok, how is this state intervention to be effectuated? The answer that can be given is also very similar to the Keynesian case. In a closed economy both countercyclical fiscal and monetary policies and the regulation of the financial markets are rather simple. In closed economies, taxes and interest rates can be raised or lowered by well-known methods relatively easily. Similarly, financial markets can also be regulated in closed economies relatively easily and without damaging consequences. If some financial inventions as structured and synthetic instruments are too complicated to be controlled, they can be prohibited. Problems arise in open economies, and they are the greater the more the economy is open.

This leads to the favorite topic of Soros: the lack of political leadership in the United States. Even now when the relative power of the U.S. is much smaller than it used to be in the previous, post World War II. decades, only the domestic problems of the United States can cause world-wide problems, the domestic problems of the other countries remain isolated problems which can be solved by themselves or by the international agencies. The theoretical problems of the control of international finances are difficult or perhaps impossible to solve if the partners are equal. The fact that the

U.S. is "more equal" makes the problem manageable, because the problems of international finances can be reduced to the problem of U.S. domestic finances as it is obviously true now. The international financial crisis is therefore the consequence of the U.S. domestic financial crisis. This reasoning can also be extended to the fundamental imbalances of the world economy, the origin of which can also be traced back to U.S. domestic problems: the lack of domestic savings, etc.

The historical analogy is obvious. Lack of political leadership under President *Herbert Hoover* led to the Great Depression. Lack of political leadership under President *Bush* led to the present turmoil. This is not my analysis; this is the logical extension of the Soros analysis. This reasoning leads to the obvious conclusion. Worldwide financial problems are the consequence of U.S. domestic financial problems and if the latter could be solved, worldwide financial problems would cease to exist and financial problems appearing elsewhere would be reduced to local problems. This, in this form, is obviously a simplification but a simplification that facilitates the grasping of the core of the problem and pointing to its solution.

This reasoning goes against the current trend of decreasing the role of politics because of the obvious deficiencies of politicians. Rudiger Dornbusch stated that "money is something too serious to be left to politicians", to which it is added now that budget is also too serious to be left to them. This, however, deprives society from the means to control the economy, which leads to crises like the present one. The way out therefore is not undoing the role but raising the level of politics and politicians.

György Szakolczai

Notes

1 An excellent description of the crisis can be found in Győrffy (2008).

2 Securitization means the creation of tradable securities from the nontradable assets of the banks by bundling, unbundling and rebundling the different financial assets. This allows the separation of exchange rate, interest rate and most recently also credits risks. The risks connected with the individual and non.tradable assets can be concealed by using this technique and this technique can therefore increase the value of the combined assets created in this way above the value of the original nontradable assets. See also note 3

3 Structured and synthetic instruments are the securities created in the way described in footnote 2. These new derivatives reduced or seemed to reduce the overall risk of the whole system.

4 Equity leveraging means buying stock and other securities for speculative purposes from credit taken up to finance this activity. If the value of the stocks and other securities increases, as it was assumed, the credits taken up can be paid back easily. If the speculator's expectations are not fulfilled and he incurs losses and particularly heavy losses, the credits cannot be repaid and the loss of the bank is unavoidable.

5 According to Győrffy (2008): "Highrisk, subprime borrowers can be classified into two groups: Alt-A and subprime. In the Alt-A category, risk derives from the fact that loans were taken out at a very low level of documentation, e.g. the income certificate was missing or no declaration was submitted on any other mortgage that may have encumbered the property. In the subprime category, risks were signalled by a poor credit history or the complete failure to repay a former loan. In 2000, the aggregate ratio of these two categories within total mortgage loans represented 4 per cent only. This figure rose to 25 per cent by early 2007 and nearly 40 per cent of mortgages issued in 2006 fell in these categories."

6 Moral hazard appears when the person or institution bearing the risk differs from those ob-taining the profit expected from the transaction. Such a situation certainly involves excessive risk-taking and may lead to heavy losses.

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