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George Soros' *New Paradigm for Financial Markets*

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*ILMR Editors**

I. Introduction

The financial crisis of the last year has provoked debate, aroused speculation, and renewed interest in the viability of our financial system. One of the most successful hedge fund managers of the last few decades, George Soros, has rarely shied away from criticizing what he perceives to be the shortcomings of free-market economics, and his latest book is no exception. In *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What it Means*,[1] Soros provokes thought about the global credit crisis, but falls short of providing a workable new paradigm for global financial markets. This book review explores Soros' latest work in the context of the current market and explains why the new paradigm fails to meet expectations. Part II provides background information about Soros and draws connections between his experiences and his work. Part III then summarizes the book itself, with emphasis on Soros' theory of reflexivity. Finally, Part IV explores both positive and negative critical analyses of Soros' work—most notably, his theory of reflexivity.

II. George Soros: The Failed Philosopher, Successful Speculator, and Left-Wing Political Activist

George Soros is a self-described "failed philosopher"[2] and "successful speculator"[3] whose past has influenced the progressive political ideology represented by his economic ideas as revealed in *New Paradigm*. Born in Budapest in 1930, George Soros is one of the most controversial living financiers. Hailed by some as a visionary

* The ILMR editors responsible for writing and editing this book review include David Fazzolare and Natalia Martins Merino, J.D., J. Reuben Clark Law School, Brigham Young University (2009), and Erin Bradley, Tyler Hawkes and Valerie Paul, J.D. candidates, J. Reuben Clark Law School, Brigham Young University (2010).

1. George Soros, The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means (2008). The book contains 162 pages (along with a lengthy introductory section), and the ISBN is 1-58648-683-9.

2. *Id.* at 12 (referring to the lack of success of his economic and philosophical theories, including reflexivity).

3. *Id.* at 106.

and scorned by others as a "bleeding heart liberal,"[4] he has headed multiple societies, donated billions to charity, and is currently number twenty-nine on the list of the world's billionaires.[5] In addition, he has impacted the world of finance with his theories and investment strategies. While this review mainly focuses on his latest book, a basic familiarity with his biographical and philosophical background is helpful to understanding the forces and ideas shaping his writing. His experiences have clearly shaped his economic beliefs, as evidenced by the lengthy autobiographical sections of his book.[6]

His biography is full of interesting events, which helped influence and frame his outlook on life, including growing up as a Jew in Hungary during the Second World War and observing his father's attitude towards money. He declined to follow his father's philosophy to make only as much money as "was necessary to make ends meet"[7] and chose instead to study Economics in London. There he was introduced to the ideas of Karl Popper, which would impact his own theory of reflexivity, and in some ways, fueled him to begin working in earnest in the financial sector to demonstrate the validity of his theories.[8]

Soros learned arbitrage trading in the 1950s and moved to the United States where he started working diligently as a trader until the early 1960s. Eventually he became one of the first hedge fund managers and went on to achieve his current level of wealth through a series of incredible speculative successes. Despite the "failure" of—or, perhaps more aptly, lack of public receptivity to—his theory of reflexivity, George Soros distinguished himself through several audacious styles of investing[9]. He is famous for "breaking the [English] pound,"[10] where he reportedly gained one billion dollars on a single day through short selling the pound,[11] as well as for

4. Stan Tyminski, *Soros – Real Father of Reforms in Poland*, Sep. 15, 2002, at 4, http://www.transduction.com/stanpdf/soros.pdf.

5. The World's Billionaires, http://www.forbes.com/2009/03/11/worlds-richest-people-billionaires-2009-billionaires_land.html (last visited Aug. 21, 2009).

6. SOROS, *supra* note 1, at 12–25, 106–22.

7. *Id.* at 13.

8. *See id.* at 13–17.

9. *See* Matthew Vadum and James Dellinger, *Billionaires for Big Government: What's Next for George Soros's Democracy Alliance?*, FOUNDATION WATCH, Dec. 2008, *available at* http://www.freerepublic.com/focus/f-news/1947269/posts (last visited Aug. 21, 2009).

10. Oliver August & Alasdair Murray, *Soros Loses $2bn as Market Rout Takes Toll*, THE TIMES, Oct. 31, 1997, Stock Market, at 28.

11. *See id.*

triggering the crash of some Asian currencies several years later through similar practices.[12] French courts have even convicted him of insider trading for investments made in a French bank.[13] In addition, his Quantum Fund, one of the first private hedge funds, increased from $1,000 in 1969[14] to $5.5 billion in just thirty years.[15]

Although he self-professedly has not yet made "enough" money[16] through his controversial investments, he has founded several philanthropic organizations and has donated billions of dollars to charities and causes[17] focusing primarily on "foster[ing] the development of open societies."[18] His quest for open societies has included support for the democratization of Eastern European countries and donations of substantial amounts to African projects.[19]

Of more particular interest are his donations to political organizations. As expressed throughout *New Paradigm,* Soros appears to have a marked antipathy for George W. Bush and his administration,[20] having accused the now former U.S. President of sullying the principles of democracy[21] and, more recently, creating the perfect regulatory environment for the current economic crisis.[22]

12. Steven Erlanger, *Malaysia's Conspiracy Theory Draws Criticism from Albright*, N.Y. TIMES, July 29, 1997, at A8.

13. Floyd Norris, *Insider-Trading Conviction of Soros Is Upheld in France*, N.Y. TIMES, Mar. 25, 2005, *available at* http://query.nytimes.com/gst/fullpage.html?res=9E05E5D8173FF936A15750C0A9639C8B63.

14. Bruce Fenton, *Who is George Soros?*, FENTONREPORT, Mar. 19, 2007, http://investing.fentonreport.com/2007/03/who-is-george-soros.html (last visited Aug. 21, 2009).

15. *Id.*

16. Deborah Solomon, *Question for George Soros: Indebted to Liberal Causes*, N.Y. TIMES, June 11, 2006, Magazine, at 18.

17. Executive Bios: George Soros, http://www.soros.org/about/bios/a_soros (last visited Aug. 21, 2009).

18. *Id.*

19. *Id.*

20. *See, e.g.*, SOROS, *supra* note 1, at 41–44 (asserting that an aide in the Bush administration, "presumably Karl Rove," was actively "promot[ing] the manipulation of truth as a superior approach [to understanding reality]" and concluding that the administration's manipulative approach to reality posed a serious danger to the concept of open society); *id.* at 124 ("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."); *id.* at 158 ("Unfortunately this [Bush] administration shows no understanding of the predicament in which it finds itself.").

21. *See* Solomon, *supra* note 16; *see also* George Soros, Speech to the National Press Club: Why We Must Not Re-elect President Bush (Sep. 28, 2004), *available at* http://www.commondreams.org/views04/0928-16.htm (explaining Soros' opinion on President Bush's foreign policy and other issues).

22. *See generally* SOROS, *supra* note 1.

Since 2003, Soros has spent millions of dollars to either remove President Bush from office or defeat his initiatives.[23]

As a result, conservative commentators often characterize Soros as an "ultra left-wing"[24] philanthropist and investor. It is at times difficult to ignore the conclusion that his liberal political disposition echoes or informs his approach to economic principles. Indeed, in *New Paradigm* he clearly announces his bias against many traditional economic models and theories, especially those on the conservative end of the spectrum. This perspective is underscored through frequent and recurring references to the failure of the Bush administration and the need for a different type of investment strategy—that is, as Soros specifically states, one initiated and supported by those on the other side of the political aisle.[25]

However, the reality of his liberal political viewpoint should be considered only as one factor in evaluating his work, not as the determinative element. And it would be extremely unwise for those who may disagree with Soros on politics to dismiss his book without seriously analyzing and evaluating his theories—especially given his extensive knowledge of, and success in, the financial markets. The rest of this review examines the theories presented by this controversial financial figure to determine their utility and practicability.

III. A BRIEF SUMMARY OF SOROS' *NEW PARADIGM*

New Paradigm attempts to convince the reader that there is a need for a new paradigm for financial markets because the prevailing paradigm does not accurately explain market behavior. In *New Paradigm*, Soros introduces his theory of economics, called reflexivity, which he posits as the basis for this new paradigm.

23. *See* Solomon, *supra* note 16 (explaining that George Soros spent approximately $27.5 million on anti-Bush groups).

24. *See, e.g.*, American Flag Blog—The Vast Left Wing Conspiracy, http://www.flagstuff.com/blog/2006/10/06/the-vast-left-wing-conspiracy/ (last visited Aug. 21, 2009).

25. SOROS, *supra* note 1, at 142 ("Major new initiatives will have to await the new president, and only a Democratic president can be expected to turn things around and lead the nation in a new direction.").

A. A New Paradigm Must Replace Equilibrium Theory Because the Latter Fails to Accurately Explain Market Behavior

Soros calls for a new paradigm by taking issue with the existing paradigm based on the classical economic theory "that financial markets tend towards equilibrium."[26] Although Soros concedes that equilibrium theory has its merits,[27] he blames it for the development of regulatory policies that allow financial markets to function with little oversight.[28] Soros refers to policies that give deference to free markets as "market fundamentalism" and claims that "market fundamentalism is no better than Marxist dogma."[29]

Soros states that market fundamentalism is based on the theory of perfect competition introduced by Adam Smith and refined by classical economists.[30] But he fails to specifically address how perfect competition gives rise to market fundamentalism other than to imply that because government intervention in free markets has always been flawed, some have inferred that free markets are always perfect.[31] He does not explicitly state, but appears to imply, that market fundamentalism is based on the flawed premise that equilibrium theory is correct and market prices will correct themselves as markets move towards equilibrium.[32]

Soros contends that this prevailing paradigm cannot explain how the current credit crisis is unfolding.[33] More importantly, he blames the prevailing paradigm that markets move towards equilibrium as the primary reason for the credit crisis in the first place.[34] In particular, Soros believes that equilibrium theory and market fundamentalism led regulators to shirk their responsibility by relying on the free market to "correct its own excesses."[35]

Contrary to market fundamentalism, which assumes that the

26. *Id.* at 73. Soros boldly asserts that the "prevailing paradigm is false and urgently needs to be replaced." *Id.* at 6.

27. *Id.* at 72.

28. *Id.* at 74.

29. *Id.*

30. *Id.* at 92.

31. *Id.*

32. Soros does state that "markets do not necessarily tend toward equilibrium" and that left alone, markets are given to extremes characterized by excessive advances and excessive declines. *Id.*

33. *Id.* at 102.

34. *Id.*

35. *Id.*

market is always right, Soros bases his new paradigm on the opposite assertion that "financial markets are always wrong."[36] Although he describes the new paradigm's premise, it is difficult to explain exactly what the new paradigm entails because Soros only discusses it in terms of what it does, rather than what it is.[37] Soros essentially reiterates that the new paradigm represents a rejection of market fundamentalism, without offering any positive alternative paradigm.

B. The Theory of Reflexivity: A Basis for the New Paradigm?

Soros' theory of reflexivity is better stated and understood as the theory that it is impossible to predict the outcome of future events involving human intervention. Soros bases his theory of reflexivity on the premise that humans cannot have perfect knowledge of the world because they are a part of it.[38] From this premise Soros concludes that people with imperfect knowledge function in two ways.[39] The first, "cognitive function," is where people seek to perfect their imperfect knowledge by trying to gain a better understanding of their situation in the world.[40] The second, "manipulative function," is where people with imperfect knowledge seek to improve their status by manipulating situations advantageously.[41]

Dismissing the notion that these two functions operate in isolation,[42] Soros concludes that when these two functions operate together, individuals cannot make decisions based on knowledge.[43] Soros asserts that when the cognitive and the manipulative functions operate together, peoples' intentions and expectations affect the premises on which they base their knowledge.[44] But because intentions and expectations involve future uncertainties, an individual's perception of the world as she understands it cannot be

36. Soros views financial markets as both a poor predictor of economic downturns and a root cause of them. *Id.* at 76.

37. For example, Soros asserts that the new paradigm approaches leverage more cautiously than the old paradigm. *Id.* at 78. Elsewhere he says that the new paradigm interprets financial markets as a historical account. *Id.* at 104.

38. *Id.* at 3.

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.* at 4.

44. *Id.*

considered knowledge.[45] In other words, as people try to understand a world influenced by other people, there is a "two-way connection" between one person's understanding of the world and the world as it is really is. As such, a person's expectations are often unmet because others' actions change circumstances in a way that the person did not expect. This "two-way connection" is called reflexivity,[46] and it further states that the natural result of reflexive situations is that outcomes may differ from expectations.[47]

Applying this reasoning to the financial world, he describes the boom-bust model for the world of finance and contends that the "boom-bust pattern is . . . a convincing example of reflexivity."[48] Soros' boom-bust model has eight stages and begins "with a prevailing bias and a prevailing trend."[49] In the first stage, no one recognizes that a trend exists. In the second stage, the "trend is reinforced by the prevailing bias." Soros argues that during this stage, "the process approaches far-from-equilibrium territory." [50] The second stage may be followed by a testing period in stage three where prices may decline from the prevailing trend temporarily.[51] Assuming that the prevailing bias and prevailing trend "survive the testing," the normal rules become inapplicable and "far-from-equilibrium conditions" are reached in stage four.[52] Stage five presents a "moment of truth" when prices cannot be sustained based on "exaggerated expectations," followed by a "twilight period" in stage six "when people continue to play the game although they no longer believe in it."[53] Stage seven occurs when "a crossover point is reached," characterized by downward trending prices and a reversed bias, all of which leads to stage eight, an accelerated downward price movement commonly called a crash.[54]

45. *Id.*

46. *Id.* at 5. Soros explains that "[r]eflexive situations are characterized by a *lack of correspondence* between the participants' views and the actual state of affairs." *Id.*

47. *Id.*

48. *Id.* at 102.

49. Soros points to the conglomerate boom as an example of a prevailing bias and a prevailing trend—"a preference for rapid earnings growth per share" and "the ability of companies to generate high earnings growth per share by using their stock to acquire other companies selling at a lower multiple of earnings," respectively. *Id.* at 65.

50. *Id.*

51. *Id.* at 66.

52. *Id.*

53. *Id.*

54. *Id.*

Other than stating that the boom-bust pattern describes market behavior in a way that contradicts equilibrium theory, Soros does not explain how the boom-bust model relates to reflexivity.[55] Instead, he explains that there are forms of reflexivity other than boom-bust patterns, and that "two-way, reflexive connections are much more common in financial markets than boom-bust sequences."[56] If these examples and explanations of reflexivity seem vague or confusing, it is because they are. Soros' description of reflexivity and reflexive situations in financial markets leave the reader wondering whether reflexivity means anything other than difficulty in predicting the future.

IV. ANALYSIS

With his book Soros succeeds at provoking debate on how to deal with the financial crisis, but nothing more. He fails to convince the careful reader that there is a need for a new financial paradigm, he falls short of providing a workable new paradigm for financial markets, and his lengthy autobiographical detours distract the reader from the purported purpose of the book—to revolutionize economic theory.

A. Soros Succeeds at Provoking Debate on How to Deal with the Financial Crisis

Soros succeeds in provoking debate about how best to deal with the current credit crisis by making the case that this crisis is "the worst financial crisis since the 1930s"[57] and calling for a new paradigm to deal with it. Soros asserts that the current crisis is global and "marks the end of an era of credit expansion based on the dollar as the international reserve currency."[58] For example, after the Internet bubble burst in late 2000, interest rates fell and continued to decrease after the terrorist attacks on September 11th.[59] Routinely funded subprime mortgage loans resulted in a bust in the housing market as well.[60] Because bankers repackaged and sold mortgages as

55. *Id.* at 102.

56. *Id.* at 70. Because people investing in the stock market always make decisions based on imperfect knowledge, Soros asserts that market prices reflect the prevailing bias resulting from these misconceptions rather than "correct valuations." *Id.*

57. *Id.* at vii.

58. *Id.*

59. *Id.* at xiv–xv.

60. *Id.* at xvi.

investments, the housing bust caused a panic with global ramifications.[61] The breakdown of the mortgage system put pressure on the banking system, which in turn faltered.[62]

Exacerbating these problems, the crisis "has spread from one segment of the market to others. . . .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."[63] Soros contends the bigger problem is that financial markets and financial authorities have not recognized the problem, leading him to "the conclusion that both the financial authorities and market participants harbor fundamental misconceptions about the way financial markets function."[64] Thus, Soros calls for a new paradigm to better understand how financial markets function.

B. Soros Fails to Convince the Careful Reader There is a Need for a New Financial Paradigm

Soros' remarkable success as an investor gives him a voice few investors have attained. His standing gives his ideas a platform to encourage discussion of the issues he raises. The passion he brings to his books demonstrates the reality of the current crisis, and the potential foresight of a man some have called "a successful prophet of the markets."[65] However, when analyzing his book, his high profile and success as an investor must be divorced from the merits of the ideas he presents.

These ideas center on the "theory of reflexivity." Classical economists likely view Soros' explanation of reflexivity as an elaborate reinvention of the wheel. Economic theory holds that boom–bust cycles result as markets strive to find equilibrium, that is, appropriate prices for assets. Economists, psychologists, and historians study economic bubbles *ad nauseam* trying to understand what causes this phenomenon.

Soros' theory of reflexivity adds very little to the current understanding of economic bubbles. The equilibrium theory explains

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61. *Id.* at xvii.

62. *Id.*

63. *Id.*

64. *Id.*

65. John Authors, *A Successful Prophet of the Markets*, FIN. TIMES, May 19, 2008, *available at* http://www.ft.com/cms/s/0/304f1e6e-253b-11dd-a14a-000077b07658.html?nclick_check=1.

that bubbles emerge as temporary market imbalances that will be smoothed out over time; the bubbles "pop" and smooth out the imbalances. The equilibrium theory assumes that the markets are right at least some of the time, but not always.[66] In fact, showing when bubbles exist before the collapse has proven nearly impossible, with one economist comparing it to "trying to predict a first-pitch curve-ball."[67] Thus, while imperfect, the equilibrium theory allows investors to view the cycles in the market as *attempts* to find an appropriate price for the assets involved. Economics provides a framework to view these bubbles as temporary disturbances that the "invisible hand" will remedy over time. Reflexivity really asserts little more than that the markets behave irrationally at times. Classical economics never asserts that markets always behave rationally, and reflexivity adds nothing to the explanation.

Soros' explanation of the boom-bust cycle also offers nothing not already explained by economists.[68] For example, he states that "far-from-equilibrium conditions" cannot be explained adequately using the equilibrium theory, but then fails to address how reflexivity explains the corrections more clearly.[69] Classical economics simply holds that bigger deviations lead to bigger corrections. If the market is really "far-from-equilibrium," the pull back to equilibrium will be a certainty. Soros adds no real enlightenment to the situation in *New Paradigm*. Merely stating that markets sometimes reach prices far from where they should be does not result in a new paradigm; after all, economists have recognized bubbles for hundreds of years. Thus, Soros' theory of reflexivity fails to add any real understanding to economic theory.

C. Reflexifity Falls Short of Providing a Workable New Paradigm for Financial Markets

Reflexivity also fails to provide a practical solution to the shortcomings of the free market—or, at the least, Soros' explanation of it fails. He bemoans the fact that "market fundamentalism" was unable to "correct its own excesses." But a common name for a large

66. Marc Goedhart, *Do Fundamentals or Emotions Drive the Stock Market?*, THE MCKINSEY Q., Apr. 13, 2005, *available at* http://www.cfo.com/article.cfm/3839631.

67. Earl A. Thompson and Charles R. Hickson, *Predicting Bubbles*, 8 GLOBAL BUS. & ECON. REV. 217, 224 (2006), *available at* http://www.econ.ucla.edu/thompson/Predicting%20bubbles.pdf.

68. *See* SOROS, *supra* note 1, at 65–69.

69. *Id.* at 72.

drop in the market is a "correction."[70] In the market, the fall of the market price of goods brings investors who took poor risks back to reality. Soros fails to explain how someone wielding "reflexivity" could correct the market more efficiently. This begs the question at the root of "the new paradigm": What assurance would the market have that a "market czar" would be more efficient at setting realistic prices than a free market?

But perhaps the best example of the practical limits of reflexivity can be found in Soros' own investment strategy. A famous and colorful quote by Soros' own son, Robert, shows the very limited role reflexivity has played in his father's investment decisions: "the [real] reason he changes his position on the market or whatever is because his back starts killing him. It has nothing to do with reason. He literally goes into a spasm, and it's this early warning sign."[71] Surely Robert has employed a healthy dose of hyperbole and sarcasm, but the quote does suggest that Soros' real genius may be as much intuition as reason.[72] This may also help elucidate how applying the theory of reflexivity to Soros' own investment strategies leaves serious, unexplainable gaps in the record.

D. Soros' Autobiographical Detours Distract the Reader from the Purported Purpose of his Book

The purpose of Soros' work is to explain his theory of reflexivity and how it should form the basis of a new paradigm for financial markets. But Soros spends much of his time on autobiographical detours and asides that distract the reader from that purpose. In the introduction, Soros gives a roadmap that states he will devote the first part of his book to the theory of reflexivity.[73] He then qualifies this statement by saying that this theory "goes well beyond the financial markets."[74] By so doing, Soros allows himself the flexibility to spend forty-seven pages (of the 162-page book) discussing his past career failures and successes. The lengthy autobiographical sketches and real-time market experimentation in the book suggest to the reader that either Soros was trying too hard to make the book long enough to be publishable length, or that he simply enjoys

70. *Id.* at 102.

71. *Id.* at 20–21.

72. *See* RICHARD L. PETERSON, INSIDE THE INVESTOR'S BRAIN 70–71 (2007).

73. *See* SOROS, *supra* note 1, at x.

74. *Id.*

writing about himself and took advantage of another outlet for his vanity. (Perhaps this latter theory explains why his name is several times larger on all sides of the cover than the title of the book itself.

Soros takes an entire chapter to discuss his failure as both a philosopher and a mathematician.[75] Later in the book, he uses another chapter to discuss his success as a financial speculator.[76] In the subsequent chapter, Soros describes a real-time market experiment to showcase his abilities as a financial speculator. He documents his thoughts and decisions beginning with January 1, 2008 and continuing through March 23, 2008. This short exercise gives the reader a small glimpse into Soros' psyche, but does little to show his theory of reflexivity at work. Perhaps if he had spent an entire year documenting his work before publishing the book, the experiment might have resonated better with readers and provided more insight into his new paradigm. Although they articulate Soros' reasons for his career choice, these chapters do little to actually advance his theory of reflexivity or explain the new paradigm.

Much of Soros' book is devoted to explaining his philosophies, but he never clearly demonstrates their applicability to the current crisis. Soros continually tries to convince readers that the theory of reflexivity is an economic theory. He follows his boom-bust explanation with an example of a company that "is a little too asymmetrical to serve as a good illustration."[77] Readers will find it hard to believe that Soros' theories work when the example he gives does not clearly support his theory at work. However lengthy his explanations may be, they do little to prove the economics behind his theory of reflexivity. All the explanations of his philosophy leave readers thinking that his theory of reflexivity is merely based on social science.

V. CONCLUSION

Ultimately, *New Paradigm* proves to be little more than a short autobiography, a partial treatise on "reflexivity," and a platform for Soros to criticize the policies of the free-market system. However, as with many critics, he fails to offer any new insights into the current financial crisis, and especially fails in accomplishing his stated goal: to unleash a new paradigm for global financial markets that discredits

75. *See id.* at 12–24.

76. *See id.* at 106–21.

77. *Id.* at 67.

and replaces classical economists' equilibrium theory. Perhaps a more appropriate title would be: "Reflexivity: Markets Are Not Always Right." But, after all, who would be interested in that?