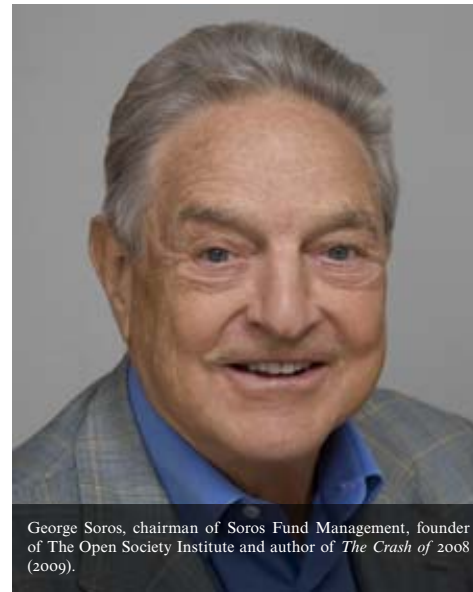


# MARKETS ARE BUBBLE-PRONE

The fact that the authorities have intervened whenever US prosperity has been threatened has reinforced the misconception that financial markets should be left to their own devices, says George Soros.



George Soros, chairman of Soros Fund Management, founder of The Open Society Institute and author of *The Crash of 2008* (2009).

**Which role has mainstream economics – and perhaps also the business press – had in the onset of the global crisis? Both categories failed to predict it.**

I think it was possible to recognise the possibility of a world financial crisis as early as three years ago, but of course this was not what most analysts were expecting. I have always taken a different view of the market and actually predicted that a global financial crisis would come much earlier than it did. I cried wolf first with *The Alchemy of Finance* in 1987, then with *The Crisis of Global Capitalism* in 1998. Only recently did the wolf arrive.

**Mainstream economics has so far been very successful in silencing opposition and marginalising different perspectives. Will the crisis lead to fundamental changes for these professions?**

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**“Had financial authorities succeeded in containing the subprime crisis, this would have been seen as just another test passed instead of the reversal point.”**

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Since market fundamentalism is built on false assumptions, its adoption in the 1980s as the guiding principle of economic policy was bound to have negative consequences. Indeed, we have experienced a series of financial crises since then. Whenever a crisis endangered the prosperity of the United States – such as the savings and loan crisis in the late 1980s, or the collapse of the hedge fund Long Term Capital Management in 1998 – the authorities intervened, finding ways for the failing institutions to merge with others and providing monetary and fiscal stimulus when the pace of economic activity was endangered. These crises served, in effect, as tests that reinforced the misconception that financial markets should be left to their own devices. Had financial authorities succeeded in containing the subprime crisis, this would have been seen as just another test passed instead of the reversal point.

**Your “new paradigm” has profound consequences for both economists and investors. The ability to predict outcomes by rational analysis is much more limited than most want to admit. The future of prognosis looks bleak. But still most of us find it hard to manage without at least some idea of what will happen. Is there some workable compromise between a justified scepticism concerning the ability to predict and the need to have at least some scenario of the near future? As an investor you must have confronted this problem all the time. So what is your general advice to all of us?**

We are facing a period of greatly increased uncertainty where the range of possible outcomes is much broader than in normal times, so firm predictions are out of the question. However, we can make some firm predictions of what the future will not look like. The post-World War II period of credit expansion will not be followed by an equally long period of credit contraction. Boom-bust processes are asymmetric in shape: a long, gradually accelerating boom is followed by a short and sharp bust. Consequently, most of the credit contraction can be expected to occur in the near term and the resumption of credit expansion is unlikely to occur at the rates to which we have become accustomed.

I developed my own theory of financial markets and published it some twenty years ago. This theory has guided me throughout my investment career and it has enabled me both to anticipate this crisis and to cope with it. Let me briefly state the two propositions on which my view of financial markets is based. First, financial markets do not reflect prevailing conditions accurately: they provide a picture that is always biased or distorted in one way or another. Second, the distorted views held by market participants and expressed in market prices can, under certain circumstances, affect the so-called fundamentals that market prices are supposed to reflect. This two-way circular connection between market prices and the underlying reality I call reflexivity.

Now that equilibrium theory has shown itself to be a failure at both prediction and explanation, the idea that reflexivity introduces an element of uncertainty into financial markets in particular must be given some credence. The theory of reflexivity is different in character from equilibri-

um theory: equilibrium theory claims to be a scientific theory offering universally valid generalisations that can be used reversibly to provide determinate predictions and explanations. The theory of reflexivity offers no such claim. It contends that, whenever it occurs, reflexivity – through simultaneous interplay between facts involved and the participants’ biased perception of them – introduces an element of indeterminacy into the course of events; therefore it would be inappropriate to look for theories that provide determinate predictions.

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**“... it would be inappropriate to look for theories that provide determinate predictions.”**

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**Concerning the philosophy of investors, could you describe the role that Karl Popper’s philosophy has played for you as an investor?**

Indeed, my most pervasive influence, other than my father’s, came from Karl Popper. It was the philosophy of Karl Popper that made me question the assumptions on which the theory of perfect competition is based, in particular the assumption of perfect knowledge. Nearly sixty years ago, I began to think about reflexivity, an idea I arrived at while examining footnotes of Karl Popper’s *Open Society and Its Enemies* dealing with the problem of self-reference: people’s understanding is inherently imperfect because they are part of a reality and a part cannot fully comprehend the whole. I subsequently came to understand that market participants cannot base their decisions on knowledge alone, and their biased perceptions have ways of influencing not

only market prices but also the fundamentals that those prices are supposed to reflect. Decisions are based not on the actual situation confronting the participants, but on an incomplete understanding, or perception, of that situation. Reflexivity seeks to illuminate the relationship between thinking and reality, and my understanding of reflexivity has guided me in both financial markets and in my philanthropy.

**It seems clear that the crisis has altered the position of the market both in a practical sense (the state having intervened on a large scale) and in a theoretical sense (market fundamentalism having lost much or most of its credibility). Will it also change the perception of the state? I am not only thinking of its role as a regulator, but also of the fact that state-owned or state-controlled companies play an increasingly important role in the global economy. Will the shortcomings of the market that have become manifest with the crisis alter the view of the state as an economic actor in this respect?**

The interesting thing is that what needs to be done in the short term is almost exactly the opposite of what needs to be done in the long term. When you have a collapse of credit, there’s only one source of credit that is still credible, and that’s the state. Then you have actually to inject a lot more leverage and money into the economy; you have to print money as fast as you can, expand the balance sheet of the Federal Reserve, increase the national debt. And that is, in fact, what has been done, which is the right thing to do. But then once this policy is successful, you have to rein in the money supply as fast as you can.

I think it’s right to extend government credit to

replace the collapsing credit. When the flow of credit restarts, suddenly there will be a flip-flop where the fear of deflation will be replaced by the fear of inflation. The pressure for interest rates to rise will be very, very strong, and the rise in interest rates could choke off the recovery. And so we are facing a period of stop-go, or stagflation similar to but more severe than what we faced in the Seventies. But that is a favourable outcome compared to what would have happened if we hadn't done what we are doing.

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About regulation, we have to start by recognising that markets are actually bubble-prone. They create bubbles. Therefore, they have to be regulated. I want to make it clear that I am not an advocate of over-regulation. I contend that markets are imperfect but I also recognise that regulators are even more imperfect. They are not only human; they are also bureaucratic and subject to political influences. Having gone too far in deregulating markets there is now a natural tendency to go overboard in the opposite direction. Now is the time to re-examine the broad principles that should guide regulation, but excessive regulation should be resisted.

**How much of a force will state-owned or state-controlled economic actors become in the global economy in the near future?**

We can expect that government, particularly in the United States, will play a disproportionately large role in the economy because it is almost the sole source of new financing. It will come to own a significant part of the banking system and, through the banks, a significant stake in commercial real estate. It will also have a major say in the motor industry, but hopefully not too many others.

China's economy has in some ways benefited from strong state influence; when the government says lend, the banks lend. If last year's stimulus programme proves inadequate, China is also in a better position to apply additional stimulus. This puts China in a strong position to recover from the recession, and that is in fact what is happening. As a result, we can expect China's power and influence to grow.