

## Soros, George - The New Paradigm for Financial Markets

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Can we observe the market objectively, being participants as well? What is reflexivity, and why is it a must to understand it? What is George Soros' long-term scenario for the financial markets? This book consists of two parts: (1) Perspective and (2) The Current Crisis and Beyond. The second part is good. The first is great. For the first time, I believe I understand his thoughts on the two driving forces behind reflexivity. And now, in the current dangerous monetary experiment - it's obvious why it's so important to understand, especially for the professional investor. This well written book is a great improvement in explaining his philosophy – far better than the more famous *Alchemy of Finance*.

George Soros needs no introduction. His accomplishments as a hedge fund manager are legendary, and his philanthropy for “Open Societies” is impressive. But his efforts within Economic Theory have not been successful so far. One of the first chapters is even called “Autobiography of a Failed Philosopher”. One hundred years from now, I would not be surprised if he is mainly remembered as a philosopher. We are moving away from the theory of equilibrium and its stepdaughter, the theory of rational expectations. Complexity Guru Dooyne Farmer said recently at a Soros-sponsored Institute for New Economic Thinking seminar in Berlin that economics has not really improved during the last 50 years. But a lot is happening now, and the theory of reflexivity seems to be a part of the journey.

Soros' philosophical starting point is that our understanding of the world is inherently incomplete because we are part of the world we try to understand. “Reflexivity can be interpreted as a circularity, or two-way feedback loop, between the participant's views and the actual state of affairs. People base their decisions not on the actual situation that confronts them but on their

perception or interpretation of that situation. Their decisions make an impact on the situation (the manipulative function), and changes in the situation are liable to change their perceptions (the cognitive function).”

The new paradigm states that instead of being always right, the financial markets are always wrong. “The illusion that markets manage to be always right is caused by their ability to affect the fundamentals that they 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. More often the prevailing bias corrects itself before it can affect the fundamentals. But the fact that they can occur invalidates the theory of rational expectations. When they occur, boom-bust processes can take on historic significance.” When does this happen and what can be done? These are the remaining questions for the theory of reflexivity to answer for it to be of great value. Misconceptions of the situation and leverage are probably parts of the answer. But unlike the current paradigm of utopian economics - that tries unsuccessfully to be deterministic like a natural science, based on ridiculous assumptions - the theory of reflexivity does not claim to make predictions in time.

The other part of the book – the current crisis and beyond – is still interesting even though it was written several years ago. Soros focuses on the Housing Bubble and its big brother, the Super-Bubble, which is a cocktail of globalization, liberalization (market fundamentalism) and the ever increasing credit expansion to avoid recessions and banking system risks.

I believe every reader will have second thoughts about their beliefs after they have finished this book. It's intriguing. George Soros will be remembered as a true free thinker.

Michael Persson, May 5, 2012