

## George Soros – “The Authorities have Lost Control”

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Fund manager George Soros sought to explain the global financial crisis through his theory of “reflexivity” to a packed auditorium at MIT last week. Soros’ October 28 talk was titled “A New Paradigm for the Financial Markets,” which is also the title of his recently published book on reflexivity.

Reflexivity, originally developed by Soros over 50 years ago, argues that the measurement of valuations in the market affects the valuations themselves, and the result can be a disequilibrium where prices undershoot or overshoot their true values.

Traditional economics argues that actors make decisions rationally so as to maximize their personal gains. But Soros’ theory is based on inefficient markets, where actors often make mistakes, and those mistakes feed on themselves in a self-reinforcing manner.

Many economists dismiss reflexivity as amateurish. “It is difficult to conceive of a more mistaken understanding of the profession’s research in the last 10-15 years,” wrote Christopher Neely, an economist at the Federal Reserve Bank of St. Louis.

Soros’ theories are not grounded in any specific mathematical formulation. Nonetheless, reflexivity is central to his thinking, and it played a role in his correctly predicting the current crisis. It is also central to an investment philosophy that has helped him amass a personal net worth estimated to be \$9 billion.

“I think I have a theory that explains the current crisis better than the existing paradigm,” Soros said at MIT.

Bubbles are a natural consequence of reflexivity — a result of the “reinforcement of trends,” according to Soros. Two elements must be in place for a bubble to form: There must be an underlying trend, such as the increasing use of leverage, and there must be a misinterpretation or misconception. In the case of the dot-com bubble, he said there was a misinterpretation of technology — people did not understand what the internet could and could not do.



“Initially, reality confirms both the trend and the misconception,” Soros told his audience. But then the trend becomes a self-reinforcing process, eventually making the misconception “so glaring it is unsustainable,” he said. What was initially self-reinforcing becomes self-defeating; a bubble results.

But bubbles are “an exception,” he said. “Usually markets correct themselves.”

The current global economy, however, is facing the bursting of a “super bubble” that has been growing for 25 years. The housing bubble served as a “detonator,” Soros said, but the real problem is the global “explosion” that resulted — Soros’ “super bubble.” The explosion owes to two factors: the expansion of credit and leverage, and a misguided belief — he calls it “market fundamentalism” — that markets would be self-correcting. These factors emerged during the Ronald Reagan and Margaret Thatcher era of the 1980s, and they were propagated through globalization, market deregulation, and the freedom to engage in financial engineering.

“The problem was that regulators believed the market was self-correcting,” said Soros. He blamed regulators for incremental interventions, like facilitating mergers and fiscal and monetary policy responses — steps he said were taken “to avoid affecting the real economy.”

“Each crisis was a successive test of the misconception of market fundamentalism,” Soros said, adding that policy responses “reinforced these misconceptions.”

“Now, authorities have lost control,” Soros said.

### **The Crisis Spreads to the Periphery**

Soros was careful to point out that the current crisis was not due to an “external shock.” It was a self-generated crisis, with origins within the US economy. The pivotal mistake, he said, was allowing Lehman to default. “Effectively, the financial system melted down,” Soros said. “The authorities then had to throw all considerations of moral hazard out the window.”

“Basically, all developed countries decided they could not allow another major institution to default,” he said. “They effectively guaranteed the deposits in all institutions.” But Soros said there was an unintended consequence of this: a flow of capital from the periphery to the center of the financial markets.

As the crisis unfolded, countries on the “periphery” (emerging markets) were forced to guarantee bank deposits to stem the flow of capital out of their markets.



The IMF was then forced into a new mission: protecting the countries on the periphery “against the storm at the center.”

“Unless the US now leads an international effort to stabilize the system, including the periphery, the system will not continue,” said Soros. He expects the next president to do this. Otherwise, he said, a different system will emerge, and the US will not be able to exert the same influence it currently enjoys.

Soros admitted underestimating the global fallout from the credit crisis. “I thought the periphery would be more unscathed than what turned out,” said Soros. The Chinese and Indian markets went down a lot more than he anticipated. He also admitted that he did not anticipate the recent strength of the US dollar. Both mistakes have cost him money in his fund management.

### **Marxism meets Capitalism**

Soros recounted the causes of the housing bubble, noting in particular that lenders assumed they could reduce risk with the geographical diversification offered through securitization. In fact, he said, this actually increased risk, because it separated the agent and the principal. Those who loaned money and earned fees – the agent - were disconnected from the homeowners that were on the hook for the payments – the principal. The agent and the principal did not share the incentive to pay the mortgage in a timely manner.

“Marx made the same mistake,” Soros said: “He didn’t understand the agency-principal problems” that would arise when everything was nationalized.

Now there are 20 million homes with mortgages that exceed home values, Soros believes. As employment rises, he said, it will be “socially acceptable” for homeowners to walk away from their homes. He believes that mortgage balances need to be reduced to 80% of the current value of homes to provide an equity buffer, in case home values fall by another 10% or so.

Soros said the current administration has been “consistently lagging” in its policy responses, specifically singling out Treasury Secretary Henry Paulson. “Paulson did not recognize the severity of the crisis and did not take the necessary steps,” Soros said. He also admitted he did not correctly forecast the severity of the crisis himself.



## **A Three Part Solution**

Soros outlined a three-part solution for the global crisis.

The first priority he sees is the need to restart lending. He supports the current plan to recapitalize banks as a means to encourage them to lend. He noted that injecting equity into banks has 12 times the impact of having the government purchase banks' bad loans, since banks are usually leveraged by a factor of 12.

But Soros' plan differs from the government's. He would provide capital through convertible debt with a low coupon, and he would offer subscription rights to existing shareholders to avoid diluting their stake. He would also make accepting this capital compulsory and base it on a review of capital requirements by bank examiners. He would provide capital sufficient to achieve the leverage ratio of 12 (i.e., approximately 8%). Then he would lower the minimum capital requirements to 6% to encourage banks to lend.

This plan mirrors the policies Norway used to solve its banking crisis in 1988-1992, and it avoids nationalizing the banks, he said.

The second part of Soros' plan is to prevent housing prices from overshooting on the downside, which requires preventing foreclosures. He has advocated the use of a system that was implemented in Denmark. Home mortgages would be converted to individual bonds, which would trade freely in the open market. These bonds would be secured by the home and by the banks that issue them. Homeowners could prepay mortgages by purchasing the bond and, since the bond values would move in tandem with home values, the possibility of home values moving into negative territory is reduced.

The third — and most ambitious — component of Soros' plan is designed to stabilize the global economy. Here, he offered only a general outline of his solution, which would allow those countries with stable finances to run fiscal deficits in order to stimulate the global economy. "That is the only way you can avoid a worldwide Depression," he said.

Beyond these three steps, Soros believes regulators must take responsibility for preventing bubbles, though he admitted that they currently do not have the tools to do so. "Monetary tools alone are not enough," said Soros. He advocates allowing margin levels to adjust based on market levels, an approach he says would limit volatility due to, for example, short selling.



## **Final Predictions**

Soros did not offer any thoughts as to the direction of equity markets or whether market indices right now are over- or undervalued.

But he did predict that the financial industry will not be as profitable as it has been. "It will not be 25% of the market capitalization of the stock exchange or 40% of its profitability," he said.

He also predicted that one-half to two-thirds of hedge funds will close. Beyond this, "certain business models that rely on extensive leverage will be unworkable," he said. "The shoe has not yet fallen" in the leveraged loan business, he said. Those deals will "not be doable in the future."

Lastly, he said the next victim of the current crisis will be the automobile industry, which he predicted will lead to "a bailout on top of the \$700 billion plan."

These predictions were tempered when Soros offered the self-deprecating admission that with, all his "great, deep understanding," he did not get the credit crisis right.

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